2020

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Article

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We thank Lily Batchelder, Jake Brooks, Len Burman, Lily Faulhaber, Brian Galle, Bill Gentry, Chye-Ching Huang, Michael Lang, Greg Leiserson, Rich Prisinzano, John Ricco, Dan Shaviro, Michael Schler, Eric Toder, and participants at the National Tax Association Annual Conference on Taxation, the Georgetown University Law Center Tax Law and Public Finance Workshop, the Duke University School of Law Tax Policy Workshop, the Boston College Law School Tax Policy Collaborative, the NYU School of Law Faculty Workshop, and the Vienna University Colloquium on European and International Tax Law for helpful comments and suggestions. We are grateful to our research assistants John Custer and Natalie Kannan. All errors are our own.

INTRODUCTION

The 2017 tax legislation[1] introduced significant new preferences[2] for business income and a new conversation on tax reform. The legislation reduced the top corporate rate to 21%[3] and introduced the new Section 199A deduction for qualifying business income earned through "pass-throughs."[4] Many commentators criticized the overall distributional effects of these changes—which disproportionately benefitted taxpayers with the highest incomes—and the flawed design of the pass-

1. Pub. L. No. 115-97, 131 Stat. 2054 (2017) [hereinafter *The 2017 Tax Legislation*].

2. By "preference" this Article refers to the fact that the 2017 legislation generally taxes business income earned by the highest income taxpayers at lower rates than it taxes ordinary individual income subject to the top marginal rates. *See infra* notes 103–05 and accompanying text.

3. *The 2017 Tax Legislation*, *supra* note 1, § 13001 (codified at I.R.C § 11 (2017)). In this Article, unless otherwise specified, the term "corporation" refers to an entity taxed under § 11 and subchapter C of the Internal Revenue Code, and the terms "corporate rate" and "corporate system" similarly refer to the applicable rules under subchapter C. *See also infra* notes 48–52 and accompanying text (describing the entity classification rules).

4. *The 2017 Tax Legislation*, *supra* note 1, § 11001 (codified at I.R.C. § 199A (2017)). Of course, the 2017 tax legislation also introduced many other changes beyond the scope of this Article. *See infra* note 80. This Article focuses in particular on changes in the 2017 tax legislation affecting the taxation of business income earned by high income taxpayers, and the different tax reduction opportunities available in the corporate and pass-through systems. *See infra* Part I.B.

through deduction, but tacitly accepted or even praised the corporate rate cut as a response to international pressures.[5]

These changes also prompted renewed calls for progressive tax reforms, to counteract the regressive effects of the 2017 legislation and to increase the share of the tax burden paid by the wealthy. For example, in early 2019, recently elected Representative Alexandria Ocasio-Cortez proposed a 70% top individual income tax rate on the highest-income taxpayers.[6] Leading progressive thinkers defended the proposal, arguing that a higher rate in this range would maximize revenues from the wealthiest taxpayers[7] and address economic inequality.[8]

This Article bridges these conversations on the 2017 legislation's new preferences for business income and the future of progressive tax reform and introduces a theoretical framework for understanding their interaction. In particular, this Article reassesses these conversations in light of what it terms "the progressivity ratchet"—a path dependence in the structure of the tax system whereby the tax treatment of certain portions of the income tax base can determine the degree of progressivity across the income tax system, measured in terms of net taxes

5. *See infra* Part I.C.1.

6. *See* Veronica Stracqualursi, *Ocasio-Cortez Suggests 70% Tax for Wealthy To Fund Climate Change Plan*, CNN POLITICS (Jan. 4, 2019, 10:57 AM), https://www.cnn.com/2019/01/04/politics/Alexandria-ocasio-cortez-tax-climate-change-plan/index.html [https://perma.cc/P28U-FTLM]. This change would represent a significant increase from the top marginal rate at the time of approximately 40%. I.R.C. §§ 1(a)–(d), (j), 1411 (net investment income tax), 3101(b), 3111(b) (Medicare payroll taxes).

7. *See* Paul Krugman, Opinion, *The Economics of Soaking the Rich*, N.Y. TIMES (Jan. 5, 2019), https://www.nytimes.com/2019/01/05/opinion/alexandria-ocasio-cortez-tax-policy-dance.html. As Krugman notes, an approximately 70% top rate would be consistent with the revenue-maximizing rate calculated by some leading economists and the top federal income tax rate in prior decades. *Id.*; *see also* Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 J. ECON. PERSP. 165, 171 (2011) (calculating a revenue-maximizing rate of 73% using their preferred parameters); Christina D. Romer & David H. Romer, *The Incentive Effects of Marginal Tax Rates: Evidence from the Interwar Era*, 6 AM. ECON. J.: ECON. POL'Y 242, 269 (2014) (calculating a revenue-maximizing rate of 74% based on responsiveness to tax rates during the inter-war era).

8. *See, e.g.*, Emmanuel Saez & Gabriel Zucman, Opinion, *Alexandria Ocasio-Cortez's Tax Hike Idea Is Not About Soaking the Rich: It's About Curtailing Inequality and Saving Democracy*, N.Y. TIMES (Jan. 22, 2019), https://www.nytimes.com/2019/01/22/opinion/ocasio-cortez-taxes.html.

paid by those at the top relative to others.[9] The progressivity ratchet suggests a different assessment of the corporate rate cut and the new pass-through deduction from how these changes have been typically assessed in the literature to date, and explains how these changes will obstruct proposals for future progressive tax reform. In particular, this Article argues why both the corporate rate reduction and the pass-through deduction should be understood as core structural failings of the 2017 legislation which will limit the progressive potential of the income tax system.

The progressivity ratchet begins with familiar analysis from the literature on optimal tax design. One basic principle, which this Article terms the "neutrality principle," provides that policymakers should tax close substitutes—goods or activities where an increase in the price of one induces a shift to the other[10]—similarly to minimize taxpayer avoidance responses that will result in revenue loss and efficiency costs.[11]

This Article expands on this traditional analysis in the public finance literature to explain when the introduction of a

9. The term "ratchet" refers generally to a device that "engages to prevent reverse motion." *Ratchet*, SHORTER OXFORD ENGLISH DICTIONARY (6th ed. 2007). In this case, the device would be preferences for business income introduced by the 2017 legislation and the reverse motion would be a more progressive system that raises more revenue from the wealthiest taxpayers. As described *infra* in Part III.A, the ratchet can also operate in reverse, whereby higher taxes on a portion of the base can enable progressive taxation on other portions of the tax base. This Article focuses on the progressivity ratchet's role in the federal income tax, although the same analysis could also be extended to other tax instruments.

10. *See* HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 330–36 (9th ed. 2010) (explaining how taxation on one good can induce shifting to another).

11. *See, e.g.*, David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 J. LEGAL STUD. 71, 71 (2000) ("[L]ines should be drawn so that a transaction or item is taxed like its closest substitutes."). This principle traces back to the classic finding by Frank Ramsey on the optimal tax rates on different commodities, which will depend upon the degree to which taxpayers substitute between higher and lower taxed commodities. *See generally* F. P. Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47 (1927). Ramsey concludes in part that "rival" commodities should be taxed "such as to leave unaltered the proportions in which they are consumed." *Id.* at 59. Among other implications, this framework suggests that close substitutes should face similar tax rates. Ramsey's commodity tax analysis can also be applied to activities in an income tax facing differential rates. *Cf.* Weisbach, *supra*, at 75 ("Although the motivation behind this paper is the income tax, the structure of this problem is similar to the standard optimal commodity tax problem.").

new preference in response to an initial preference either mitigates or compounds tax avoidance opportunities generated by the initial preference (and thereby the effect of the progressivity ratchet) and highlights the first-order importance of the legal rules defining the new preference.[12] The systemic impact of a new preference—such as the new business tax preferences in the 2017 legislation—will depend on whether it increases opportunities for taxpayers to avoid higher taxes on other portions of the base, and more generally whether it violates the neutrality principle. If an initial preference cannot be eliminated, the neutrality principle suggests that a second tax preference may be desirable to the minimize the revenue loss and tax avoidance resulting from the initial preference.[13] This would be the case if the rules defining the new preference effectively target income that would otherwise shift to the preexisting preference and the second preference can instead tax that income at a higher rate.[14] In that case, adding a second preference (or more) may be more desirable than just one, as the second preference may have the effect of taxing close substitutes more neutrally and preventing substitution toward the lowest taxed category. Adding a poorly targeted new preference, in contrast, will compound the effect of the initial preference and increase the efficiency costs and revenue loss resulting from tax avoidance.[15]

In the traditional framework, the primary problem with introducing a poorly targeted preference would simply be the increased efficiency costs from raising revenue. While this effect may be independently undesirable, this Article describes the potentially more significant implications of this analysis for policymakers desiring to increase the progressivity of the tax system—and thereby to raise more revenue from the wealthiest

12. *See infra* Part II.B.

13. *See infra* Part II.B.

14. S*ee* discussion *infra* Part II.B.1; *cf.* Weisbach, *supra* note 11, at 77 (describing how, in the presence of one distortionary tax, it can be efficiency enhancing to add a second distortionary tax which reduces the distortionary effects of the first tax).

15. This Article's conceptual framework explaining the proper analysis of preferences introduced in response to other preferences can be applied broadly when analyzing possible tax reforms. The discussion in this Article focuses on applying this framework to evaluate proposals to raise rates on high income taxpayers and the business preferences that disproportionately benefited them in the 2017 legislation. *See infra* notes 160–61 and accompanying text.

taxpayers[16]—when they face certain political constraints on how they can progressively raise additional revenue. This analysis suggests that the introduction of greater opportunities for tax avoidance can generate the progressivity ratchet, which can in turn limit policymakers to less progressive outcomes if they do not reverse the tax preferences allowing the new avoidance opportunities.[17]

Specifically, this Article describes how the progressivity ratchet can result from the interaction of greater opportunities for tax avoidance with one or more of three related background constraints policymakers may face in progressively taxing the wealthy.[18] The first possible constraint arises to the extent policymakers are concerned with the efficiency costs from taxing the wealthy (the "efficiency cost constraint").[19] In that case, policymakers may determine to collect less tax revenue from the wealthy than they would otherwise, if additional revenue entails a higher efficiency cost as the wealthy incur costs to avoid the rate increases. A second possible constraint arises when policymakers face political obstacles to increasing progressivity by simply raising the top statutory rates (the "salience of tax rates constraint").[20] In this case, greater opportunities for tax avoidance will reduce the revenue collected at the chosen top rate. A final possible constraint similarly arises if policymakers choose to tax the wealthy at the revenue-maximizing rate (the "revenue maximizing rate constraint").[21] In this case as well, greater opportunities for tax avoidance will reduce the revenue collected at this maximum rate.

These constraints may be driven by the preferences of constituents, the independent preferences of the policymakers, or some combination thereof. Regardless of their source, the constraints link legal rules that give greater opportunities for tax

16. For a discussion of why a more progressive tax system may be desirable, see *infra* notes 278–82 and accompanying text.

17. *See infra* Part IV.C.

18. This Article's framework does not seek to comprehensively describe all the ways greater tax avoidance may affect progressivity, but it is meant to lay out plausible conditions under which a violation of the neutrality principle that leads to greater tax avoidance will undermine progressivity.

19. *See infra* Part III.A.1.

20. *See infra* Part III.A.2.

21. *See infra* Part III.A.3.

planning to the outcome of less revenue in the end being collected from taxpayers at the top of the distribution.

When policymakers face any of these three constraints, the tax treatment of certain portions of the tax base can have systemic consequences for overall progressivity in the tax system. The progressivity ratchet can operate in either direction: higher taxes on a portion of the tax base can enable greater overall progressivity—after taking into account the effects elsewhere in the system—whereas new preferences for a portion of the tax base can constrain overall progressivity. However, while the ratchet can operate in either direction, this Article focuses on the case of the 2017 legislation where a new preferences in the tax system—the corporate rate reduction or Section 199A—constrain the progressive potential overall of the tax system, by undermining effectiveness of higher taxes on other portions of the tax base.

This framework implies a different assessment of the business tax changes in the 2017 tax legislation than is commonly found in the literature to date. Proponents of the corporate rate cut argued that it was necessary to achieve closer neutrality with falling foreign rates and to stop U.S. multinational corporations (MNCs) from shifting profits and investment to lower tax foreign jurisdictions.[22] In that case, the initial preference is the lower taxes foreign jurisdictions imposed on mobile income, and the new preference, introduced in response to this initial preference, is the corporate rate cut. Many commentators consequently justified the corporate rate cut as a desirable response to pressures on the international tax system.[23]

22. For instance, the House Republican leadership justified a large corporate rate cut as bringing the United States rate more in line with other countries. *See* GOP, A BETTER WAY: OUR VISION FOR A CONFIDENT AMERICA 24 (2016) [hereinafter GOP, A BETTER WAY], https://www.novoco.com/sites/default/files/atoms/files/ryan_a_better_way_policy_paper_062416.pdf [https://perma.cc/T2RC-WY49] (asserting that the average OECD corporate tax rate today is 24.8% while the U.S corporate tax rate remains at 35%); *see also* DANIEL N. SHAVIRO, DECODING THE U.S. CORPORATE TAX 168–69 (2009) (describing competition for reported profits and actual investment as the two justifications that advocates offered for lowering the corporate tax rate); Nigel Chalk et al., *The Tax Cuts and Jobs Act: An Appraisal* 6 (IMF, Working Paper No. WP/18/185, 2018) ("[T]he reduction simply restores the U.S. to the relative position it had in the early 1990s, at around the OECD norm.").

23. For academic commentary justifying the corporate rate cut as a desirable response to pressures on the international system, see, for example, Mi-

This Article's framework explains, however, why these changes to the corporate system violated the neutrality principle and are likely, if not reversed, to increase the efficiency costs from raising additional revenue. The claimed benefits of a lower corporate rate—in reducing profit shifting and increasing domestic investment[24]—are likely small relative to the new avenues for tax avoidance that the corporate rate cut generated. In this respect, the corporate rate reduction may be understood as a core structural failing of the 2017 legislation.

chael J. Graetz, *Foreword—The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy*, 128 YALE L.J.F. 315, 320 (2018) (noting the importance of the international competition for profits and concluding that "a significantly lower corporate rate has been long overdue, and raising it would be a mistake"); Reuven S. Avi-Yonah, *How Terrible Is the New Tax Law?: Reflections on TRA17* 5 (Univ. Mich. Law & Econ., Working Paper No. 18-002, 2018) ("On the corporate side, the main change is a long overdue reduction of the rate to 21% . . . ."); Chalk et al., *supra* note 22, at 5 ("Most observers regard a cut in the statutory rate of corporation tax as long overdue."). Other commentators did not necessarily embrace the corporate rate cut, but also did not prominently target it for reversal, as they do for other changes in the 2017 legislation. For instance, Jared Bernstein, a leading progressive economic advisor and commentator, wrote a list of tax changes that progressives should consider in addition to raising the top individual income tax rate, and it included eliminating the pass-through deduction but not raising the corporate rate. Jared Bernstein, *Building on Ocasio-Cortez: More Progressive Ways To Raise Much-Needed Tax Revenues*, WASH. POST (Jan. 16, 2019), https://www.washingtonpost.com/outlook/2019/01/16/building-ocasio-cortez-more-progressive-ways-raise-much-needed-tax-revenues/?utm_term=.748fbdb27694. Some politicians—although few academics—then justified Section 199A as an additional preference necessary to preserve neutrality between domestic corporate and pass-through income in light of the corporate rate cut. *See, e.g.*, 163 CONG. REC. S7674 (2017) (statement of Sen. Portman) (defending the pass-through deduction as "try[ing] to have some more parity between the pass-through companies and the so-called C corporations"); Press Release, Ron Johnson, U.S. Senator, Johnson Statement on Current Tax Reform Proposals (Nov. 5, 2017) [hereinafter Sen. Johnson Press Release], https://www.ronjohnson.senate.gov/public/index.cfm/2017/11/johnson-statement-on-current-tax-reform-proposals [https://perma.cc/G5CN-TRER] ("[I]t is important to maintain the domestic competitive position and balance between large publicly traded C corporations and 'pass-through entities.'"); *see also* SCOTT GREENBERG & NICOLE KAEDING, TAX FOUND., REFORMING THE PASS-THROUGH DEDUCTION 2 (2018), https://files.taxfoundation.org/20180621095652/Tax-Foundation-FF593.pdf [https://perma.cc/BMZ8-HEGS] ("Supporters of the deduction argue that it . . . helps put the pass-through sector on an equal footing with the largest multinational corporations.").

24. *See infra* Part IV.A.

A second strain of commentary—to which we contributed—criticized the 2017 legislation, and particularly the design of Section 199A, for the many new "tax games" that it would invite.[25] This Article provides the conceptual framework to understand why the provision violates the neutrality principle, and, thus, likely compounds the progressivity ratchet. The Article also explains how Section 199A is, to a significant degree, a symptom of the problem generated by the corporate rate cut, rather than a unique flaw in the legislation.[26] At the very least, the corporate rate reduction and Section 199A both reflect a similar mistake: Congress's failure to properly apply the neutrality principle.

The consequences of these mistargeted preferences are not limited to their regressive effects and their incentives to costly tax planning—both design flaws that have received attention in the literature so far, particularly in the case of Section 199A.[27] More importantly, these changes are likely to constrain future progressive reforms unless they are reversed.[28] This path de-

25. *See, e.g.*, David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439 (2019) (detailing a range of tax planning maneuvers possible under the new law including Section 199A); Daniel Shaviro, *Evaluating the New U.S. Pass-Through Rules*, 218 BRITISH TAX REV. 49, 51 (2018) ("The pass-through rules stand front and centre in illustrating both the 2017 Act's sloppiness and its lack of principle.").

26. *See infra* Part IV.B.

27. *See infra* Part I.C.1.

28. Early reactions to Representative Ocasio-Cortez's proposal to raise the top individual rate have generally underappreciated how the changes to the business tax system in the 2017 legislation would obstruct this reform. *See infra* notes 283–86 and accompanying text. The Penn Wharton Budget Model estimates that 35% of ordinary income earned by those with adjusted gross income above $500,000 came from pass-throughs before the 2017 legislation. E-mail from John A. Ricco, Senior Analyst, Penn Wharton Budget Model, to David Kamin, Professor of Law, N.Y. Univ. Sch. of Law (Feb. 13, 2019, 1:14 PM EST) (on file with authors) [hereinafter Feb. 13 Ricco E-mail]. If Congress raises the individual rates but preserves the low corporate rate, much of this individual income could shift to the corporate tax system. *See infra* Part IV.C. Commentators have warned of the general threat that a corporate rate cut could present to progressive taxation. For instance, Professor Daniel Shaviro has cautioned that lowering the corporate rate could undermine the progressivity of the individual income tax as taxpayers shift their income—and particularly their labor income—from the individual to the corporate system. *See* SHAVIRO, *supra* note 22, at xii–xiii ("[A] large gap between corporate and individual rates is a potential tax-planning bonanza for taxpayers who can shift

pendency in the tax system—potentially setting the country on a course toward a less progressive fiscal system over the long-term—could be the more lasting legacy of the 2017 legislation and these business tax preferences. This Article concludes by considering some of the possible avenues for policymakers to "reverse the ratchet" and enable future progressive reforms. One direction is to simply revert to the prior relationship between the individual and corporate systems, which generally penalized the corporate form and reserved the corporate system for companies requiring access to public equity markets.[29] This approach, while it has received little support so far in the literature, is likely to be more desirable, and less costly, than the tax structure resulting from the 2017 legislation.[30] This Article's framework also contextualizes a range of alternative reforms proposed in the prior literature that could break the ratchet by improving the targeting of new preferences or by eliminating initial preferences in the tax system, and suggests how policymakers can weigh these alternatives.[31]

The remainder of this Article proceeds as follows. Part I begins by describing key features of the business tax system before 2017, the key changes in the 2017 legislation, and some of the most salient assessments of these changes in the literature to date. Part II then builds upon the basic neutrality principle to explain when introduction of a new preference does or does not increase the efficiency of raising additional revenue, with a particular focus on how well the legal rules defining the new preference target those eligible for the initial preference. Part III extends this analysis and introduces the idea of the "pro-

their income into a corporate entity and avoid the second layer of tax. It also raises serious questions about fitting a lower corporate rate into an overall system that may still be intended to distribute tax burdens progressively."); *see also infra* note 143 (summarizing various opinions on corporate tax policy). This Article builds on this prior work by first contextualizing the trade-offs from a corporate rate cut within this Article's neutrality framework focused on the legal rules defining tax preferences, and then explaining why both the corporate rate cut and Section 199A are misguided attempts to pursue neutrality in the tax system in light of this framework.

29. *See infra* Part IV.D.1.

30. As described *infra* notes 309–11 and accompanying text, this approach could still address international pressures in other ways, such as through expanded base protection measures reducing the ability of corporations to substitute across that margin.

31. *See infra* Part III.B.3.

gressivity ratchet," explaining how a poorly targeted new preference can, under several plausible conditions, lead to policymakers to choose less progressivity overall. Part IV then reassesses the 2017 legislation in light of this framework and explains how its mistargeted business tax preferences, including the corporate rate cut, will obstruct future progressive tax reform. Part IV then considers possible options to "reverse the ratchet" and how to evaluate them.

I. BUSINESS TAXATION AND THE 2017 TAX LEGISLATION

This Part describes the state of the tax system under prior law, and then reviews the motivations behind the business tax preferences in the 2017 legislation, the key features of these changes, and prevalent early assessments of these changes in the literature to date.

A. THE CORPORATE AND PASS-THROUGH SYSTEMS UNDER PRIOR LAW

The federal income tax offers two systems for taxing business income: through either a corporation or a pass-through. Scholars have long debated the desirability of using two systems rather than one and the wisdom of a separate corporate tax.[32] Perhaps the strongest justification for the entity-level corporate tax is the administrative convenience from taxing large, publicly-traded companies with frequent changes in ownership at the entity level, rather than attempting to attribute the entity's profits to the individual owners each year. By contrast, smaller privately-held businesses might not require entity-level taxation and can be taxed more easily as pass-throughs at the level of the individual owners.[33] The discussion

32. For a general summary of the primary justifications for—and problems with—a separate corporate tax, see SHAVIRO, *supra* note 22, at 3–42.

33. *See id.* at 13 ("By using the entity as a collection vehicle, one centralizes administration of the tax and needs only a single reporting taxpayer."); David A. Weisbach, *New Equity Integration*, 71 TAX L. REV. 1, 26–27 (2017) ("By taxing the income at the shareholder level, a shareholder allocation system ensures that the income is taxed much the same as it would be if it were earned outside of the corporation. Notwithstanding the accuracy it would provide, shareholder allocation systems are widely viewed as unadministrable in the publicly-held corporation context and have never been seriously proposed.").

that follows reviews the basic rates and rules governing these two systems before the 2017 legislation.

1. General Rules

Single Versus Double Taxation. Under "pass-through" taxation, the profits and losses of the business pass through to the owners' individual tax returns, with no separate entity-level tax.[34] In this system, the owners' tax consequences depend principally on when the business realizes taxable income and how the business agreement allocates that income.[35] The distribution of profits from the pass-through or the sale of ownership interests in the pass-through do not generally trigger additional tax, since the income would already have been taxed at the individual level when earned.[36]

The corporate income tax system, in contrast, taxes certain forms of business income twice: first at the entity level[37] and then at the individual level when the taxpayer receives distributions from the corporation or sells the corporate stock.[38] The double layer of tax applies only to income accruing to equity shareholders. The corporation can deduct interest payments to

34. *See* I.R.C. §§ 61(a)(2), 63 (2017) (stating that income from a sole proprietorship is taxed as part of an individual's gross income); *id.* § 701 (stating that income from a tax partnership is similarly included on the partner's individual income tax return); *id.* §§ 1361–1399 (stating that income from corporations that elect to be treated as S corporations similarly passes through to the shareholder's individual return).

35. For instance, a partner's income from a partnership is based on the partner's distributive share of the partnerships gains and losses. *See id.* § 702(a)–(c).

36. *See id.* §§ 731(a) (governing distributions), 741 (governing gain upon sale of a partnership interest). Distribution of money from the partnership can trigger gain to the distributee, but only when the money distributed exceeds the basis that the partner has in her partnership interest. *Id.* § 731(a). The partner's basis in the partnership interest is adjusted upward as the partnership recognizes income taxed at the partner level. *Id.* § 705. As a result, distributions of earnings generally do not result in additional taxable income to the distribute, and the partner generally does not recognize further gain or loss upon sale of a partnership interest unless there are underlying unrealized gain or loss upon the sale of a partnership interest unless there are underlying unrealized gains or losses on property in the partnership.

37. *Id.* § 11.

38. *See id.* § 61(a)(7) (taxation of dividends), § 61(a)(3) (taxation of capital gains). Corporations cannot deduct these amounts, which results in the "double tax" on corporate income.

debt-holders[39] and employee compensation[40] up to certain limits[41] from its base of income subject to the entity-level tax. As a result, these payments from a corporation are only taxed once at the individual level.[42]

Relative Tax Rates. In the period immediately preceding the 2017 tax legislation, the tax rules generally taxed income earned through a pass-through more lightly than income earned through a corporation. Before the 2017 tax legislation, the Code taxed corporate income at a top average rate of 35%.[43] If the corporation then immediately distributed the profits to the shareholder (or if the shareholder sold their stock), the shareholder would face an additional individual level tax of up to 23.8%.[44] The combined effective tax rate from these two layers of tax would have been approximately 50% for an owner facing the top rates.[45] As described below, however, a taxpayer may be able to reduce or eliminate the second individual layer of tax on income earned through a corporation.[46] In the extreme case, only the first layer of tax—which reached 35% before 2017—would then apply.

In contrast, the Code only taxes income earned through the pass-through at the individual level. Prior to the 2017 tax legis-

39. *Id.* § 163(a).

40. *Id.* § 162(a)(1).

41. The 2017 tax legislation capped the amount of deductible interest payments at an amount equal to the sum of the corporation's business interest income, 30% of adjusted taxable income, and floor plan financing interest. *The 2017 Tax Legislation*, *supra* note 1, § 13301(a) (codified at I.R.C. § 163(j) (2017)). The Code also limits the amount of deductible compensation paid to certain corporate executives. I.R.C. § 162(m) (2017).

42. *See id.* § 61(a)(4) (taxation of interest), § 61(a)(1) (taxation of employee compensation).

43. I.R.C. § 11(b) (2012). Prior law taxed corporate income under four general brackets, reaching 35%, plus two "bubble brackets" on income in certain ranges, so that corporations with taxable income in excess of approximately $18.33 million would pay an average rate of 35% on the entire taxable income base. *Id.* Prior law also taxed income earned by a "personal service corporation" separately at an ungraduated 35% rate, irrespective of the amount earned. *Id.* § 11(b)(2).

44. I.R.C. § 1(h)(1) (2012) set the maximum rate imposed on capital gains at 20%. I.R.C. § 1411 (2012) added an additional 3.8% Medicare Contribution tax for high income individuals, leading to a maximum tax rate of 23.8% on capital gains.

45. 100% - (100% - 35%) x (100% - 23.8%) = 50.47%.

46. *See* discussion *infra* Part I.A.2.

lation, the Code taxed ordinary income earned by an individual through a pass-through at a top rate of approximately 43.4%[47]—a rate significantly lower than the combined effective rate on corporate income subject to both layers of tax at the top rates. In order for the two systems to produce roughly equivalent tax rates on ordinary income, a corporate shareholder would have to avoid almost all of the individual layer of tax on corporate income.

Entity Classification Rules. The "check the box" regulations generally allow closely-held businesses to choose between the corporate and pass-through systems.[48] Eligible entities include partnerships, LLCs, and certain other business forms organized under state law, as well as businesses not organized at all under state law.[49] Businesses organized as corporations under state law, which are ineligible for this election, can still elect pass-through treatment as an "S corporation" if the entity is not publicly traded and meets certain other requirements.[50] Publicly-traded companies, however, are treated as taxable corporations regardless of their status under state law,[51] and generally cannot elect S corporation treatment.[52]

The combination of a tax penalty on corporations relative to pass-throughs and these choice-of-entity rules led many closely-held companies to operate as pass-throughs before the

47. The maximum statutory tax rate at the time under the individual income tax was 39.6%. I.R.C. § 1(a)–(e) (2012). Additional taxes on different forms of income increased the effective top rate by up to approximately 3.8%. *See, e.g.*, *id.* § 3101(b) (Medicare payroll tax and surtax), § 3111(b) (same), § 1401(b) (self-employment taxes), § 1411 (net investment income tax).

48. Eligible entities with two or more owners can elect to be classified either as a partnership (and be treated under subchapter K), or as an association (and be treated as a corporation for tax purposes). Treas. Reg. § 301.7701-3(a) (2019). Eligible entities with just a single owner can elect to be classified as an association (and be treated as a corporation for tax purposes) or "to be disregarded as an entity separate from its owner." *Id.*

49. *Id.* § 301.7701-2(b) (2019).

50. I.R.C. § 1361(b) (2012).

51. Publicly-traded partnerships are generally treated as corporations under I.R.C. § 7704 (2012). There are limited exceptions when a partnership primarily engages in investing activities. *Id.* § 7704(c).

52. Corporations cannot elect S corporation treatment if, among other restrictions, they have more than 100 shareholders or have any shareholders who are not individuals, which disqualifies most publicly-traded companies. *Id.* § 1361(b)(1).

2017 legislation, and largely reserved the corporate income tax system for publicly-traded companies.[53]

2. Corporate Tax Reduction Opportunities and Anti-Abuse Rules

Taxpayers may be able to use the corporate system to reduce their effective tax rate through a variety of strategies. Prior to the 2017 legislation, however, the relatively high corporate rate limited the potential benefit many taxpayers could gain by earning income through a corporation and then using these strategies, instead of earning the income through a pass-through.

The corporate system allows taxpayers to defer the second individual layer of tax until they receive a distribution from the corporation or dispose of their interest.[54] Taxpayers can take advantage of this deferral opportunity to reduce or eliminate the second individual layer of tax.[55] The taxpayer can defer the individual layer of tax entirely, for example, by holding the stock through their life and then benefitting from the "step-up" in basis at death, which entirely eliminates the second layer of

53. *See, e.g.*, George A. Plesko, *"Gimme Shelter?" Closely Held Corporations Since Tax Reform*, 48 NAT'L TAX J. 409, 415 (1995) ("Trends in the corporate sector, coupled with proposed policy changes at the federal level, suggest a diminished role for the corporate tax among all but the largest companies."); George A. Plesko & Eric J. Toder, *Changes in the Organization of Business Activity and Implications for Tax Reform*, 66 NAT'L TAX J. 855, 868 (2013) ("In contrast to the demographics of the business environment in 1986, far more businesses (in both total and percentages) are organized as pass-through entities, and they account for a far larger percentage of economic activity."); Bret Wells, *Pass-Through Entity Taxation: A Tempest in the Tax Reform Teapot*, 14 HOUS. BUS. & TAX L.J. 1, 17 (2014) ("[A]lthough Congress blocked the exit for most publicly-traded companies through the adoption of Section 7704, it left in place the means of side-stepping the corporate tax regime for non-publicly traded companies by leaving the choice of entity decision with taxpayers, and taxpayers have systematically chosen to conduct their business in pass-through entity structures in the post-1986 era.").

54. *See supra* note 38 and accompanying text.

55. Income earned through a pass-through, in contrast, flows through to the owner's individual income tax return in the year it is earned. Distributions from the business do not, in general, trigger additional taxes because the income was fully taxed as it was earned. As a result, taxpayers generally do not have a similar incentive to defer the receipt of income earned through a pass-through. *See supra* note 36 and accompanying text. *But see* Ari Glogower, *Requiring Reasonable Comp From a Corp*, 160 TAX NOTES 961 (2018) (describing potential benefits from retaining earnings from an S corporation).

tax.[56] Similarly, a taxpayer could reduce or eliminate the second layer of tax by waiting until she is in a lower bracket before taking a distribution or by taking advantage of other provisions such as the exclusion of gains on the sale of certain small business stock.[57] Finally, deferring the second layer of tax can reduce the effective tax liability if the corporation invests retained earnings in assets which would generate ordinary income to an individual investor, such as taxable interest-bearing bonds.[58]

In some circumstances, deferring the second layer of corporate tax does not reduce the effective liability. A taxpayer would not benefit from deferring the distribution of corporate earnings when the second individual layer of the corporate double tax is ultimately paid and income from reinvested earnings is subject to approximately the same tax rate within the corporation as it would be outside the corporation.[59] This would be the case for investments eligible for the long-term capital gains rate.[60] In other circumstances, however, retaining earnings within a corporation could allow the taxpayer to achieve substantial tax savings.[61]

Before the 2017 tax legislation, however, the top individual rate of approximately 43.4% did not significantly exceed the top corporate rate of 35%.[62] As a result, even if a taxpayer could entirely eliminate the second individual-layer of tax on corporate earnings, the corporate system did not offer a significant tax reduction opportunity relative to the pass-through system.[63]

56. I.R.C. § 1014 (2012); *see, e.g.*, Edward J. McCaffery, *A Voluntary Tax? Revisited*, 93 NAT'L TAX ASS'N PROC. 268, 271 (2000) (describing how a taxpayer can avoid the individual income tax through a "buy, borrow, die" strategy).

57. I.R.C. § 1202 (2012). For a more detailed description of these strategies, see Kamin et al., *supra* note 25, at 1449.

58. *See* Kamin et al., *supra* note 25, at 1451–52.

59. *See* Ari Glogower & David Kamin, *Sheltering Income Through a Corporation*, 164 TAX NOTES FED. 507, 515 (2019).

60. *Id.* at 508.

61. *Id.* (describing the potential benefits from earning income through a corporation if the retained earnings generate ordinary income or if the taxpayer can reduce or eliminate the second individual layer of the corporate double tax).

62. *See supra* notes 43, 47 and accompanying text.

63. The graduated corporate rates under prior law offered another potential advantage of using the corporate income tax system for a taxpayers who would otherwise have had income taxed at the top individual income tax rate.

These strategies offer greater benefits when the top individual rate significantly exceeds the corporate rate, which was the case in the years before the 1980s[64] and, as described below, is the case again after the changes in the 2017 tax legislation.[65]

To benefit from deferring the individual layer of tax on corporate income, however, a taxpayer would also have to avoid anti-abuse regimes for undistributed corporate earnings. Under the personal holding company rules, a closely-held corporation faces a 20% surtax on undistributed income from certain sources.[66] The rules apply to a company with five or fewer taxpayers holding a majority share and that earns "personal holding company income."[67] The accumulated earnings tax rules also impose a 20% surtax on any corporation's retained earnings beyond "the reasonable needs of the business."[68]

The effect of these anti-abuse rules will vary considerably based on taxpayers' individual circumstances and their ability to engage in sophisticated tax planning. A worker earning labor income, for instance, cannot easily form a corporation, direct her previous salary to that corporation, and retain her earnings in that corporation to defer the second individual layer of tax. This simple strategy would likely run afoul of both anti-abuse rules.[69] In other cases, more sophisticated taxpayers can skirt

In that case, a taxpayer could have benefitted from the lower marginal rates on corporate income if the corporation did not fall into the highest bracket. This opportunity was limited for service-oriented businesses by the flat 35% rate on income from personal service corporations. *See supra* note 43.

64. *Compare Historical Highest Marginal Income Tax Rates*, URBAN-BROOKINGS TAX POL'Y CTR. (Jan. 18, 2019), https://www.taxpolicycenter.org/statistics/historical-highest-marginal-income-tax-rates [https://perma.cc/VS5D-B9GD], *with Corporate Top Tax Rate and Bracket*, URBAN-BROOKINGS TAX POL'Y CTR. (July 17, 2019) [hereinafter *Corporate Rates*, URBAN-BROOKINGS], https://www.taxpolicycenter.org/statistics/corporate-top-tax-rate-and-bracket [https://perma.cc/D4MN-95BJ].

65. *See infra* Part I.B.

66. I.R.C. § 541 (2012).

67. *Id.* § 542(a). "Personal holding company income" includes income from passive investments (such as dividends or royalties) as well as "personal service contracts," which are service contracts designating a particular person to provide the services. *Id.* § 543. At least 60% of the company's adjusted gross income must be from personal holding income in order for it be labeled as a personal holding company. *Id.* § 542(a)(1).

68. *Id.* §§ 531–537.

69. The corporation would be a personal holding company subject to the surtax on retained earnings since it would have only one owner and only in-

these rules with more complex operations. For instance, firms can avoid the personal holding company rules by adding additional shareholders and the accumulated earnings tax by making business investments to justify retained earnings.[70] For these reasons, tax advisors and scholars have described the rules as "notoriously ineffective"[71] and easily avoidable by sophisticated taxpayers.[72]

MNCs could also use the corporate system to shift profits to lower-tax foreign jurisdictions. A U.S. MNC could then avoid any U.S. tax as long as it did not repatriate these profits from foreign subsidiaries,[73] while a foreign MNC would face no further U.S. liability if it shifts the profits out of its U.S. corporate subsidiary to a foreign parent or another foreign subsidiary. A series of rules sought to prevent these strategies by including tests for determining if the U.S. corporation transacted with the related foreign corporation as if it were an unrelated third party,[74] but many considered these rules insufficient, particu-

come attributable to a "personal service contract." *See supra* notes 67–68. The corporation might also be subject to the accumulated earnings tax, since it has no business reason to retain the earnings. In this case only the personal holding company surtax would apply. *See* I.R.C. § 532(b)(1) (2012) (excepting personal holding companies from the accumulated earnings tax).

70. *See* I.R.C. § 542(a)(2) (2012) (stock ownership requirement allowing more widely held corporations to avoid application of the personal holding company tax); *id.* §§ 533(a), 533(c) (exemption from the accumulated earnings tax for earnings retained for the "reasonable needs of the business").

71. Michael L. Schler, *Reflections on the Pending Tax Cuts and Jobs Act*, 157 TAX NOTES 1731, 1733 (2017).

72. *See* Edward D. Kleinbard, *Corporate Capital and Labor Stuffing in the New Tax Rate Environment* 50–56 (Univ. S. Cal., Legal Studies Research Paper Series No. 13-5, Mar. 21, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239360 (describing the limitations of these anti-abuse rules).

73. For a summary of the basic rules that taxed U.S. corporations on foreign income only when subsidiaries repatriated the funds (often called a "deferral" system), see DANIEL N. SHAVIRO, FIXING U.S. INTERNATIONAL TAXATION 54–57 (2014). As Shaviro notes, this regime was rooted in the longstanding doctrine that U.S. individuals and corporations are only taxed when income is "realized" unless a statutory provision overrides this rule. *Id.* at 55.

74. *See, e.g.*, I.R.C. § 482 (2012); Treas. Reg. § 1.482-1(b) (2019) (allowing the IRS to reallocate income and deductions among related parties in order to prevent tax evasion and to more accurately reflect the economic income of the parties).

larly for mobile and hard-to-value services and property such as intellectual property.[75]

The pass-through system also offered unique tax reduction opportunities prior to the 2017 tax legislation. The pass-through system gave taxpayers access to the preferential capital gains rate on sales of property, which does not apply to corporate income.[76] Taxpayers could also use pass-throughs to shift income through a variety of strategies.[77] Prior to the introduction of Section 199A, however, the pass-through system's integration with the individual income tax system tended to limit the scope of legal tax planning.[78] Most critically, the pass-through system did not provide taxpayers the same opportunity to defer or eliminate the individual tax by retaining earnings in the firm.[79]

75. *See, e.g.*, SHAVIRO, *supra* note 73, at 77 (describing the failure of "transfer pricing" rules governing transactions between U.S. corporations and related foreign parties); Richard L. Kaplan, *International Tax Enforcement and the Special Challenge of Transfer Pricing*, 1990 U. ILL. L. REV. 299 (1990); Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 734–38 (2011) ("Transfer pricing strategies are particularly effective because of the central role of high-value unique intangible assets as profit drivers for multinational firms."). For further discussion of the magnitude of profit shifting under prior law, see *infra* note 249 and accompanying text.

76. *Compare* I.R.C. § 1(h) (2012) (providing preferential tax rates for long-term capital gains for individuals), *with id.* § 11 (applying the corporate tax rate to all taxable income of the corporation irrespective of whether it is a capital gain). For this reason, taxpayers had little incentive to earn qualifying capital gains or dividends through a corporation.

77. For instance, members of a pass-through can try to allocate income or loss to the partner in the best tax position to absorb it because of their applicable tax rate or other losses or deductions, even as the economics of the deal might diverge from these tax allocations. *See* LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS 58 (5th ed. 2017) (describing how partners might try to specially allocate certain items of income or loss for purposes solely of reducing income tax liabilities). There are rules to try to stop these maneuvers. *See, e.g.*, I.R.C. § 704(b) (2012); Treas. Reg. § 1.704-1(a)(2) (2019) (requiring that allocations have "substantial economic effect"). These strategies will also generally only allow for the deferral—rather than the elimination—of taxes, as the tax treatment of the partners will generally catch up with their economic entitlements.

78. *See supra* note 36 and accompanying text.

79. *See supra* note 36 and accompanying text.

B. THE CHANGES IN THE 2017 TAX LEGISLATION

The 2017 law introduced significant preferences for business income earned through both corporations and pass-throughs.[80]

The Corporate Rate Reduction. The 2017 tax legislation reduced the tax on corporate income to a flat 21% rate.[81] This dramatic reduction marked a new era for the corporate tax and its role in the tax system. The change nearly halved the previous top rate of 35%[82] and resulted in the lowest top rate on corporate income in nearly 80 years.[83] At the time of passage, the change was projected to reduce corporate tax revenues by more than $1.3 trillion[84] over the following decade and to accelerate the trend of the declining share of federal tax revenues resulting from the corporate income tax.[85]

The 2017 legislation did not otherwise change the rules governing access to the corporate system, however, nor the anti-abuse rules preventing taxpayers from avoiding the second individual layer of tax by retaining corporate earnings. In fact, the law removed a rate penalty that had applied to certain kinds of service-oriented companies, which could not benefit

80. Of course, the 2017 tax legislation also changed many other tax rules affecting taxpayers and businesses. This Article focuses on particular changes to the taxation of both domestic and foreign income affecting taxpayers at the top of the income distribution.

81. *The 2017 Tax Legislation*, *supra* note 1, § 13001 (codified at I.R.C § 11 (2017)).

82. I.R.C. § 11(b)(1) (2017). The progressive rate schedule and surtaxes for income in certain brackets resulted in an average rate of 35% for corporations with taxable income above $18.33 million. *See supra* note 43.

83. Corporate income over $25,000 was taxed a top rate of 19% in 1939, before wartime revenue measures significantly increased rates beginning in the 1940s. The top rate reached as high as about 53% in the late 1960's before falling to the mid-30% range in the late 1980s. *Corporate Rates*, URBAN-BROOKINGS, *supra* note 64.

84. J. COMM. ON TAXATION, 115th CONG., JCX-3-17, ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 1, THE "TAX CUTS AND JOBS ACT," at 3 (2017), https://www.jct.gov/publications.html?func=startdown&id=5053 [https://perma.cc/8X4A-RG2R].

85. *See* J. COMM. ON TAXATION, 115th CONG., JCX-3-18, OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2018, at 27 tbl.A-3, 30 fig.A-3 (2018), https://www.jct.gov/publications.html?func=startdown&id=5060 [https://perma.cc/GE7G-QZRD].

from the previous graduated structure, thus making corporate status more attractive for a broader range of taxpayers.[86]

Section 199A. The 2017 tax legislation also introduced the new Section 199A, allowing a 20% deduction for certain forms of business income earned through pass-throughs.[87] The rules determining eligibility for the new Section 199A deduction are complex. Taxpayers with taxable income below a $157,500 threshold (doubled for joint filers) can generally claim the full deduction against their qualifying income from a trade or business.[88] For these purposes, qualifying income excludes certain forms of investment income (such as capital gains and losses, dividends and interests),[89] compensation earned as an employee,[90] and certain compensation-like payments made to an owner of an S corporation or a partnership.[91] For taxpayers with taxable income above the threshold, the amount of the deduction is further limited to either 50% of wages paid, or 25% of wages and 2.5% of the cost of invested property.[92] Finally, taxpayers in certain sectors of the economy with income above the threshold are denied the deduction altogether. These "[*s*]*pecified services*" include law, healthcare, finance, or "any trade or business where the principal asset . . . is the reputation or skill of 1 or more of its employees."[93]

The Section 199A deduction significantly reduced tax liabilities for affected businesses. For taxpayers in the top income tax bracket of 37%, the deduction effectively reduced this top rate by more than 7% to approximately 30% (before accounting

86. *The 2017 Tax Legislation*, *supra* note 1, § 13001 (codified at I.R.C. § 11 (2017)) (imposing a flat 21% rate on all corporations and eliminating the separate flat 35% rate applying to personal service corporations); *see supra* notes 43 and 63 (discussing the rules applying to personal service corporations).

87. *The 2017 Tax Legislation*, *supra* note 1, § 11001 (codified at I.R.C. § 199A (2017)). Section 199A is effective for eight years, from 2018 to 2025. I.R.C. § 199A(i) (2017).

88. I.R.C. § 199A(d)(3)(B)(ii) (2017). The restrictions imposed above the threshold phase-in over a $50,000 range above the threshold (doubled for married couples). *Id.*

89. *Id.* § 199A(c)(3)(B).

90. *Id.* § 199A(d)(1)(B). Technically, this restriction does not affect the definition of "qualified business income" but rather the definition of a "qualified trade or business." *Id.*

91. *Id.* § 199A(c)(4).

92. *Id.* § 199A(b)(2)(B).

93. *Id.* §§ 199A(d)(1), 1202(e)(3)(A).

for other surtaxes).[94] The Joint Committee on Taxation estimated that this unprecedented preference for pass-through business income in the federal income tax would cost about $50 billion per year while it is in effect.[95]

Changes to the Treatment of Foreign Income. The 2017 legislation also specifically addressed the tax rates applying to foreign income earned by both U.S. and foreign MNCs. First, in certain circumstances, the reform shifted the United States closer to a "territorial" tax system by no longer subjecting repatriated foreign earnings of U.S. MNCs to U.S. tax.[96] To prevent MNCs from taking advantage of this change to avoid U.S. taxes on income from mobile assets, the bill also included both an incentive and a penalty to encourage taxpayers to report income from these assets in the U.S. The new "foreign derived intangible income" (FDII) rules provide a deduction for income from domestic intangibles earned overseas,[97] while the "global intangible low-taxed income" (GILTI) taxes U.S. corporations (at a reduced rate) on a portion of global income from intangibles located abroad, regardless of whether such income is repatriated.[98] Finally, the bill introduced the Base Erosion and Anti-Abuse Tax (BEAT), which penalized certain payments

94. 20% of the 37% rate equals 7.4%.

95. J. COMM. ON TAXATION, *supra* note 85, at 1.

96. Specifically, the law introduced a "participation exemption" for dividends received by a U.S. parent company from foreign subsidiaries. *The 2017 Tax Legislation*, *supra* note 1, § 14101 (codified at I.R.C. § 245A (2017)). In transition, it also imposed a one-time deemed repatriation tax on deferred foreign income. *Id.* § 14103 (codified at I.R.C. § 965 (2017)). A "territorial" tax system is one in which a country taxes only the profits of corporations "sourced" to that country. A "worldwide" system by contrast taxes the worldwide profits of corporations resident in the country. SHAVIRO, *supra* note 73, at 1. The pre-2017 system was hybrid of both, as it taxed profits of U.S. corporations on a worldwide basis but often only taxed foreign profits only when repatriated. The post-2017 system is also a hybrid, but it has a different package of rules, since it still taxes some foreign profits of U.S. MNCs (with no deferral option) through the new minimum tax discussed *infra* note 98. *See* Susan C. Morse, *International Cooperation and the 2017 Act*, 128 YALE L.J.F. 362, 368 (2018) (describing how the system continues to be a hybrid of worldwide and territorial taxation).

97. *The 2017 Tax Legislation*, *supra* note 1, § 14102 (codified at I.R.C. § 250 (2017)).

98. *Id.* § 14101 (codified at I.R.C. § 951A (2017)).

from companies to related foreign parties[99] with the aim of reducing profit shifting by both U.S. and foreign-based MNCs.

Other Changes to Top Rates. In contrast to the transformative changes to the taxation of corporations and pass-through business income, the 2017 tax legislation did not significantly change other top tax rates. The legislation slightly reduced the top marginal rate on ordinary income from 39.6% to 37%.[100] Rates in this range have been the general norm for the past quarter century.[101] The 2017 tax legislation also preserved the prior top rates of tax on long-term capital gains and qualified dividends, which remained at 23.8%.[102]

Relative Tax Rates. As a result of the changes in the 2017 tax legislation (and including surtaxes), ordinary individual income is taxed at a top rate of 40.8%[103] while qualifying pass-through income is taxed at a top rate of 33.4%.[104] Corporate income is subject to top rates ranging from 21%—if a taxpayer can avoid the individual layer of tax on this income—to 39.8%[105] if the corporate income is immediately distributed and subject to the second individual layer of tax.

C. ASSESSMENTS IN THE LITERATURE

These changes in the 2017 tax legislation received conflicting receptions among many commentators. The design of Section 199A garnered widespread critique, including from some supporters of the bill's other changes.[106] The corporate rate reduction, in contrast, received tacit acceptance or even approbation from many corners as necessary to address global pressures from lower taxes on mobile income in foreign

99. *Id.* § 14401 (codified at I.R.C. § 59A (2017)).

100. *Compare id.* § 11001(a) (codified at I.R.C. § 1(j)(2017)) (setting a 37% top rate from 2018 to 2025), *with* I.R.C. § 1(a) (2017) (setting a 39.6% top rate for other years).

101. *Historical Highest Marginal Income Tax Rates*, *supra* note 64.

102. The top 20% rate under I.R.C. § 1(h)(1)(D) (2017) plus the 3.8% Net Investment Income Tax under § 1411 (2017).

103. *See* I.R.C. § 1(j)(2) (2017) (setting a 37% top marginal rate). Additional taxes on different forms of income can increase the effective top rate by up to approximately 3.8% to around 40.8%. *See supra* note 47.

104. 37% x (100% - 20%) + 3.8% = 33.4%.

105. 21% + 23.8% x (100% - 21%) = 39.80%.

106. *See infra* notes 110–15 and accompanying text.

jurisdictions.[107] A separate literature, to which we were early contributors, focused on the new planning opportunities to minimize taxes across the two systems.[108] Many commentators also criticized the legislation's explicit revenue and distributional costs.[109] At the same time, the emerging conversation advocating for raising rates on the highest earners has largely not accounted for the structural consequences of the 2017 tax legislation and how they may obstruct these efforts.

This Section summarizes these common assessments of the 2017 tax legislation in the literature to date. Part III then revisits these assessments in light of the progressivity ratchet and describes how both the corporate rate cut and Section 199A reflect the same mistakes in misapplying the neutrality principle and pose a similar structural obstacle to future progressive reforms.

1. A Tale of Two Business Preferences

The Design of Section 199A. Section 199A garnered the most sustained criticism from commentators. For instance, Professor Daniel Shaviro—a leading critic of the provision—acknowledges that Section 199A might have prevented some taxpayers from shifting to the corporate system, but nonetheless concludes that "[t]he pass-through rules stand front and centre in illustrating both the 2017 Act's sloppiness and its lack of principle."[110] Shaviro argues that the provision "direct[s] economic activity away from some market sectors and towards others, for no good reason and scarcely even an articulated bad one."[111] In a prior work, a group of law professors and practitioners—including ourselves—also described the many "games" that taxpayers could play to take advantage of the arbitrary distinctions underlying the provision, by restructuring their transactions and activities in order to access the preferential rates.[112]

Even many commentators who favored other aspects of the legislation—and preferences for business income in general—

107. *See infra* notes 122–38 and accompanying text.
108. *See infra* notes 145–53 and accompanying text.
109. *See infra* notes 154–64 and accompanying text.
110. *See* Shaviro, *supra* note 25, at 51.
111. *Id.*
112. *See* Kamin et al., *supra* note 25, at 1462–73.

still criticized the design of Section 199A. For instance, the Tax Foundation, a leading proponent of the corporate rate cut and the legislation overall, wrote that "[t]he design of the pass-through deduction leaves room for improvement" and listed a variety of flaws with the provision.[113] Economists at the International Monetary Fund (IMF), who praised the corporate rate reduction, more bluntly concluded that "[i]t would be better not to have the 20 percent deduction for certain types of pass-through income."[114] Others similarly criticized Section 199A but did not criticize the large reduction in the corporate rate.[115]

Some commentators defended Section 199A, but they were few and far between, especially among scholars and analysts. For example, in testimony before the Senate Finance Committee giving an early assessment of the recently enacted legislation, former Congressional Budget Office director Douglas Holtz-Eakin, argued that "it was an absolutely necessary part of the tax reform. You want to have a level tax playing field between the different kinds of entities. . . ."[116] Not surprisingly, policymakers responsible for the provision and industry groups who benefitted from it also continued to defend the rule.[117]

113. GREENBERG & KAEDING, *supra* note 23, at 1.

114. Chalk et al., *supra* note 22, at 19.

115. *See, e.g.*, Avi-Yonah, *supra* note 23, at 4–5 (describing the corporate rate cut as "long overdue" while criticizing the pass-through deduction as "one big problem" with the tax bill). As noted *supra* note 23, other commentators may not have embraced the corporate rate cut, but they also have not highlighted the case for its reversal, as they propose for other changes in the 2017 legislation. For instance, Jared Bernstein lists a set of tax increases progressives should consider in addition to Representative Ocasio-Cortez's 70% top rate and includes repeal of the pass-through deduction but not an increase in the corporate rate. *See* Bernstein, *supra* note 23.

116. *Early Impressions of the New Tax Law*, *Hearing Before the S. Comm. on Fin.*, 115th Cong. (2018) [hereinafter Holtz-Eakin Testimony] (statement of Douglas Holtz-Eakin, President, American Action Forum), https://www.finance.senate.gov/hearings/early-impressions-of-the-new-tax-law [https://perma.cc/BBF4-24RF].

117. *See, e.g.*, *Early Impressions of the New Tax Law*, *Hearing Before the S. Comm. on Fin.*, 115th Cong. 4 (2018) (written statement of Sen. Hatch, Chairman, S. Comm. on Fin.) (Apr. 24, 2018), https://www.finance.senate.gov/imo/media/doc/4.24%20Hatch%20Opening%20Statement%20at%20Finance%20Hearing%20on%20Progress%20of%20New%20Tax%20Law.pdf [https://perma.cc/P4E7-ZGYM] ("[W]hy would we not want to get more money back to these business owners so that they can grow their businesses, hire more employees, and improve our economy?"); *Breaking Down the Small Business Pass-Through Deduction: Who Benefits and How?*, NAT'L FED'N INDEP.

Some policymakers—though few academics or policy analysts—also justified Section 199A as maintaining neutrality between income earned in the corporate and pass-through systems.[118] For example, Senator Ron Johnson (R-WI), a leading advocate for a pass-through tax cut, argued that "it is important to maintain the domestic competitive position and balance between large publicly-traded C corporations and 'pass-through entities' (subchapter S corporations, partnerships and sole proprietorships)."[119] Similarly, Senator Rob Portman (R-OH), defending the pass-through tax cut on the Senate floor, argued that the provision was "try[ing] to have some more parity between the pass-through companies and the so-called C corporations."[120]

Echoing similar themes, a representative for the American Institute of Certified Public Accountants submitted testimony to the Senate Finance Committee supporting a pass-through tax cut: "If Congress, through tax reform, lowers the income tax rates for C corporations, all types of business entities should receive a rate reduction . . . . Tax reform should not disadvantage [pass-through] entities or require businesses to engage in complex entity changes to obtain favored tax status."[121]

BUS. (Sept. 20, 2018), https://www.nfib.com/content/analysis/alabama/breaking-down-section-small-business-pass-through-deduction-who-benefits-and-how/ [https://perma.cc/4N5Z-KA3T] ("The Small Business Pass-Through Deduction of section 199A is one of the biggest triumphs following the 2017 passage of the Tax Cuts and Jobs Act.").

118. This general concern with neutrality between the pass-through and corporate systems also predated the 2017 tax legislation. For instance, the Obama administration's tax reform efforts suggested a similar goal of neutrality in the average tax rates between the systems. *See* THE WHITE HOUSE & THE DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM 7 (2012) [hereinafter 2012 JOINT REPORT], https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-Report-Business-Tax-Reform-2012.pdf [https://perma.cc/QN4L-KURN] ("The effective marginal tax rate on new investment by C-corporations is now 32.3 percent, while the effective marginal tax rate on new investment by pass-through businesses 26.4 percent . . . . The ability of large pass-through entities to take advantage of preferential tax treatment has placed businesses organizing as C-corporations at a disadvantage.").

119. Senator Johnson made this statement in opposition to the legislation at the time while seeking an even larger preference for pass-through businesses. *See* Sen. Johnson Press Release, *supra* note 23.

120. 163 CONG. REC. S7674 (daily ed. Dec. 1, 2017) (statement of Sen. Portman).

121. *See Business Tax Reform*: *Hearing Before the S. Comm. on Fin.*, 115th

The Corporate Rate Reduction. Unlike Section 199A, the corporate rate reduction earned tacit acceptance or praise from many quarters.[122] Advocates for cutting the corporate tax rate often focused on the pressures from lower tax rates in foreign jurisdictions.[123] In their 2016 proposed tax reform framework "A Better Way," House Republicans called for a 20% corporate rate, so that "[i]nstead of having some of the highest tax rates on entrepreneurship and business activity in the world, the United States will leapfrog many of its trading partners and offer globally competitive rates."[124] The Obama administration had also similarly proposed cutting the corporate rate—if not as dramatically—to 28%, in order to reduce the disparity between U.S. and foreign rates.[125]

Two primary concerns motivated these proposals to reduce the U.S. corporate rate.[126] The first concern was profit shifting.[127] MNCs had an incentive to report profits in lower-tax for-

Cong. 70 (2018) (written statement of Troy K. Lewis, CPA, GGMA, Immediate Past Chair, Tax Executive Committee, American Institute of Certified Public Accountants).

122. *See, e.g.*, Graetz, *supra* note 23, at 315 ("By lowering the corporate tax rate from 35% to 21%, [the 2017 tax legislation] brings the U.S. statutory rate into closer alignment with the rates applicable in other Organisation for Economic Co-operation and Development (OECD) nations, thereby decreasing the incentive for businesses to locate their deductions in the United States and their income abroad.").

123. *See, e.g.*, GOP, A BETTER WAY, *supra* note 22, app. at 32 ("A high corporate tax rate discourages foreign businesses from locating and investing in the United States and puts U.S. firms at a competitive disadvantage with the rest of the world.").

124. *Id.* at 23.

125. THE WHITE HOUSE & THE DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM: AN UPDATE 5 (2016) [hereinafter 2016 JOINT REPORT], https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf [https://perma.cc/QYB6-QLRD] ("Income shifting has also grown worse as the wedge between the U.S. statutory rate and rates in other countries has widened, and the absence of reform has left strategies used to shift income untouched."). Unlike the changes in the 2017 legislation however, the Obama Administration proposal was designed to be revenue-neutral and preserve the same amount of revenue raised from corporations by offsetting the rate reduction with base-broadening measures. *Id.* at 17–19.

126. *See, e.g.*, SHAVIRO, *supra* note 22 (describing competition for reported profits and actual investment as the two justifications that advocates offer for lowering the corporate tax rate).

127. *Id.*; *see also Business Tax Reform*, *supra* note 121, at 2 (statement of Sen. Orrin Hatch, Chairman, S. Comm. on Fin.) ("The current system gives

eign countries, even if their actual economic activity occurred in the United States.[128] Evidence suggested that profit shifting was a significant and growing problem in the years leading up to the 2017 legislation.[129]

For example, IMF economists offered the following assessment of the corporate rate cut:

> The [2017 legislation] . . . mov[es] the U.S. from having been . . . an increasingly isolated outlier relative to other advanced and emerging economies to now being close to the median of tax rate imposed by other OECD countries . . . . Most observers regard a cut in the statutory rate of corporation tax as long overdue. Many of the most significant distortions implicit in the U.S. system—including incentives to shift profits outside the US (including by inverting)[130] and toward artificially high leverage—are ameliorated simply by reducing the statutory tax rate . . . .[131]

The IMF economists' assessment suggests that there is importance to lowering the U.S. corporate rate to be more neutral relative to the rates in other countries.[132] They note that some corporate income, if taxed at the full U.S. corporate rate, may shift to lower tax substitutes, such as profits that can be shifted abroad to lower tax jurisdictions.[133] The corporate rate cut thus helps address that distortion and improve neutrality along this

corporations incentives to shift income production and intangible assets, like intellectual property, from the U.S. to lower-taxed foreign jurisdictions, thereby eroding our tax base."); 2016 JOINT REPORT, *supra* note 125, at 4–5 (stating the U.S. tax system's complexity and loopholes "allow[] large corporations to reduce their tax liability by shifting profits around the globe").

128. *See* 2016 JOINT REPORT, *supra* note 125, at 5.

129. *See, e.g.*, Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond*, 69 NAT'L TAX J. 905, 918–19 (2016) (estimating that revenue loss from profit shifting was growing and, by 2012, equaled about 30% to 45% of actual corporate receipts); Thomas R. Tørsløv et al., *The Missing Profits of Nations* tbl.2 (Nat'l Bureau of Econ. Research, Working Paper No. 24701, 2018) (estimating that, as of 2015, revenue loss from profit shifting equaled 14% of actual receipts).

130. In an inversion transaction, a parent corporation changes its residence from the United States to a foreign country, typically in order to reduce profits subject to tax in the United States. *See also* Chalk et al., *supra* note 22, at 5 n.5 ("Corporate inversion is the process whereby a U.S. based company changes its legal domicile to an offshore jurisdiction, usually by merging with a foreign corporation.").

131. *Id.* at 4–5. The IMF also cited other distortions created by the corporate income tax—such as the type of economic activity—that would be reduced by the cut in the corporate rate. *Id.* at 5.

132. *See id.* at 4.

133. *Id.* at 5.

margin.[134] Other commentators expressed this same assessment, including some who specifically criticized Section 199A.[135]

Other commentators also argued that the higher U.S. rates discouraged the location of real economic investment in the United States.[136] Under this view, a corporate rate cut could also increase actual economic activity by encouraging corporations to invest in the United States.[137] For instance, Alan Auerbach suggested that a corporate rate reduction could also yield a modest increase in real investment.[138]

Some commentators did criticize the corporate rate cut.[139] Some suggested that the benefits did not justify the significant domestic revenue loss[140] or had undesirable distributional effects.[141] However, most of this critical commentary focused on

134. *Id.*

135. *See, e.g.*, Avi-Yonah, *supra* note 23, at 4 ("On the corporate side, the main change is a long overdue reduction of the rate to 21% . . . ."); Graetz, *supra* note 23, at 315–16, 320 (describing the corporate rate cut as justified given the competitive global environment for location of profits while concluding that the pass-through deduction is "unprecedented" and "troublesome").

136. *See, e.g.*, *Business Tax Reform*, *supra* note 121, at 2 (statement of Sen. Orrin Hatch, Chairman, S. Comm. on Fin.) ("Our current business tax system—and the disparity between the U.S. corporate rate and our foreign competitors' corporate rates—has created a number of problems and distortions. For example, the current system slows economic growth by impeding capital formation . . . ."); GOP, A BETTER WAY, *supra* note 22, at 9 ("The corporate tax rate represents the most important tax-related factor in a company's decision to invest and locate jobs in the United States or overseas.").

137. *See Business Tax Reform*, *supra* note 121, at 2 (statement of Sen. Orrin Hatch, Chairman, S. Comm. on Fin.).

138. *See* Alan J. Auerbach, *Measuring the Effects of Corporate Tax Cuts*, 32 J. ECON. PERSPECTIVES. 97, 115–17 (2018).

139. *See, e.g.*, MARR ET AL., CTR. ON BUDGET AND POL'Y PRIORITIES, NEW TAX LAW IS FUNDAMENTALLY FLAWED AND WILL REQUIRE BASIC RESTRUCTURING (2018), https://www.cbpp.org/sites/default/files/atoms/files/4-9-18tax.pdf [https://perma.cc/V92L-3JAL].

140. *See, e.g.*, *id.* at 2 ("These large revenue losses are irresponsible given the fiscal challenges the nation will face over the next several decades due to an aging population, health care costs that likely will continue to rise faster than the economy, interest rates returning to more normal levels, potential national security threats, and current and emerging domestic challenges such as large infrastructure needs that cannot be deferred indefinitely.").

141. *E.g.*, *id.* at 3 ("The new tax law will increase income inequality since it delivers far larger tax cuts to households at the top, measured as a share of income, than to households at the bottom or middle of the income distribution.").

the immediate and explicit costs of the rate reduction.[142] Other commentators also warned of the broader threat to progressive taxation from a corporate rate cut, both in the context of the 2017 legislation and under prior law.[143] This Article builds on that literature, by first explaining how the corporate rate cut was poorly targeted to activity that did not warrant perferences, and then describing why this mistargeting could interact with political economy constraints to limit the progressive potential of future tax reform.

2. Tax Planning Across Systems

Other commentators described how the 2017 legislation allowed taxpayers to plan across both the corporate and pass-through systems in order to minimize their tax liabilities.[144] We contributed to this literature with our report on the legislation titled *The Games They Will Play*.[145]

In our *Games* report, we described how both the corporate and pass-through preferences allow taxpayers to avoid taxation at the top individual rate.[146] The choice between the tax reduction opportunities under each system will depend on the cir-

142. *See, e.g.*, *id.* at 5–6.

143. For instance, Professor Daniel Shaviro cautioned that a low corporate rate could result in leakage from the individual income tax system. *See* SHAVIRO, *supra* note 22, at xii–xiii. Similarly, Professor Edward Kleinbard described the potential importance of taxpayers "stuffing" income into corporations and avoiding the individual income tax as corporate rates fall. *See generally* Kleinbard, *supra* note 72. Eric Toder also described the challenges created by a corporate rate cut for individual income tax. *See* Eric Toder, *Filling the Gap: Pass-Through Businesses and Tax Reform*, MILKEN INST. REV., Jan.–Mar. 2018, at 37, https://www.taxpolicycenter.org/sites/default/files/publication/138506/2001156-filling-the-gap-pass-through-businesses-and-tax-reform.pdf [https://perma.cc/RZJ5-NXLC]; Eric Toder, *Eliminate the Deduction for Qualified Business Income and Require Most Firms To Be Taxed as Pass-Throughs*, TAXVOX: BUS. TAXES (June 4, 2018) [hereinafter Toder, *Require Firms To Be Taxed As Pass-Throughs*], https://www.taxpolicycenter.org/taxvox/eliminate-deduction-qualified-business-income-and-require-most-firms-be-taxed-pass-throughs [https://perma.cc/45TF-6RRQ]. Finally, the Center on Budget and Policy Priorities has produced a more comprehensive critique of the corporate rate cut in the 2017 legislation, describing how the cut would disproportionately benefit the top of the income distribution and encourage tax sheltering. *See* MARR ET AL., *supra* note 139, at 5, 17.

144. *See, e.g.*, Kamin et al., *supra* note 25, at 1450–54, 1462–72.

145. *See generally id*. (analyzing the tax games "well-advised taxpayers" will play to avoid paying taxes).

146. *Id.* at 1445–73.

cumstances of the individual taxpayers.[147] In a subsequent article, we then described how these games result in part from the economic incoherence of the categories of activities that receive preferential treatment in both the corporate and pass-through systems.[148]

Other commentators have subsequently expanded on these ideas to highlight the significance of the different tax reduction opportunities under the two systems.[149] Professor James Repetti described how, because of the different underlying rules and tax reduction opportunities, the 2017 legislation did not achieve neutrality between the corporate and pass-through systems. Rather, one system or the other will be tax-advantaged for particular taxpayers, depending on their circumstances.[150] Repetti concluded that "the 2017 Tax Act has made tax planning more important in selecting an entity to conduct a business, not less."[151]

Similarly, Professor Bradley Borden emphasized the context-specific nature of the choice of entity decision in the wake of the 2017 law: "Now, business structuring decisions demand a more comprehensive analysis due to the highly situational nature of organizational form preferences."[152] Borden argued further that, "[i]n fact, the preferred organizational form following the [2017 legislation] may be a combination of various entities."[153] The possibility that taxpayers may now prefer a combination of entities evidences the degree to which the 2017 legis-

147. *Id.*

148. *See generally* Ari Glogower & David Kamin, *Missing the Mark: Evaluating the New Tax Preferences for Business Income*, 71 NAT'L TAX J. 789, 790 (2018) (explaining how the 2017 Tax Legislation's "incoherent approach to defining business income . . . results in business preferences to all types of economic returns . . . if these returns are earned in certain forms and in certain sectors of the economy").

149. *See, e.g.*, James R. Repetti, *The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity*, 21 FLA. TAX REV. 686 (2018).

150. *See id.* at 714 ("[T]he 2017 Tax Act has made it more difficult to predict which choice of entity will have the lowest effective tax rate in the long run.").

151. *Id.* at 688.

152. Bradley T. Borden, *Income-Based Effective Tax Rates and Choice-of-Entity Considerations Under the 2017 Tax Act*, 71 NAT'L TAX J. 613, 615 (2018).

153. *Id.*

lation failed to achieve neutrality across the systems, and in fact may have widened the cleavage for many taxpayers.

The discussion that follows builds upon these insights in the *Games* reports and the works of Repetti and Borden. Parts II and III describe conceptually when the introduction of preferences increase opportunities for tax planning and when they do not—and the consequences of these effects for progressive taxation in the presence of political economy constraints. Part IV then returns to the corporate rate cut and pass-through deductions, and explains how they are examples of poorly targeted preferences that, if retained, are likely to constrain the progressive potential from future tax reforms.

3. Revenue and Distributional Effects

Finally, many commentators criticized the explicit revenue costs and regressive distributional effects of the 2017 legislation as a whole.[154] The CBO projected that the legislation would cost nearly $2 trillion in the period from 2018–2028, after accounting for additional interest expenses and macroeconomic effects.[155] The legislation's large net cost has been a focal point of criticism, even among commentators who generally supported particular changes such as the corporate rate reduction.[156]

Commentators also criticized the explicit regressive effects of the changes in the 2017 legislation, which generally provided the largest benefits to the wealthiest taxpayers.[157] The Urban-Brookings Tax Policy Center (TPC) estimated that the lowest 80% of earners would receive an average tax cut of around 1.5% of after-tax income in 2018,[158] while the top 1% would receive

154. *See, e.g.*, MARR ET AL., *supra* note 139.

155. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2018 TO 2028, at 106 (2018), https://www.cbo.gov/system/files/2019-04/53651-outlook-2.pdf [https://perma.cc/L4UD-WUSP] (estimating an updated net cost from the legislation of approximately $1.9 trillion including interest expense and macroeconomic feedback).

156. *See, e.g.*, Graetz, *supra* note 23, at 323–24 (criticizing the effect on the deficit while generally supporting the corporate rate reduction).

157. *See, e.g.*, MARR ET AL., *supra* note 139, at 4 ("The new tax law will . . . add to the growing polarization of income and wealth of recent decades.").

158. Authors' calculations based on URBAN-BROOKINGS TAX POLICY CTR., TABLE T18-0025, THE TAX CUTS AND JOBS ACT (TCJA): ALL PROVISIONS AND INDIVIDUAL INCOME TAX PROVISIONS (2018), https://www.taxpolicycenter.org/

an average cut of around 3.4% of after-tax income.[159] Section 199A alone gives a tax cut over 20 times larger (as a share of after-tax income) for the top 1% than for the bottom 80%.[160] The distributional effect of the corporate tax cut is a matter of greater dispute, because this calculation depends on estimates of the share of corporate taxes borne, respectively, by investors, managers, and workers. A consensus view holds, however, that corporate rate cuts disproportionately benefit the corporate investors, who tend to be heavily concentrated at the top of the income distribution.[161]

Some commentators also described additional implicit effects from the 2017 legislation's changes that do not factor into the estimates of its explicit revenue and distributional effects.[162] In the future, tax increases, spending reductions, or a combination of both will likely finance these deficit-increasing tax cuts.[163] William Gale and researchers at the TPC show how, under a range of financing assumptions, taxpayers toward the

model-estimates/individual-income-tax-provisions-tax-cuts-and-jobs-act-tcja-february-2018/t18-0025 [https://perma.cc/LT3L-DPP3].

159. *Id.*

160. Authors' calculations based on URBAN-BROOKINGS TAX POLICY CTR., TABLE T18-0123, TAX BENEFIT OF THE 20 PERCENT DEDUCTION FOR QUALIFIED PASS-THROUGH BUSINESS INCOME, (2018), https://www.taxpolicycenter.org/model-estimates/individual-income-tax-expenditures-october-2018/t18-0213-tax-benefit-20-percent [https://perma.cc/3TBL-C98C].

161. *See* CHYE-CHING HUANG & BRANDON DEBOT, CTR. ON BUDGET & POLICY PRIORITIES, CORPORATE TAX CUTS SKEW TO SHAREHOLDERS AND CEOS, NOT WORKERS AS ADMINISTRATION CLAIMS 4 tbl.1 (2017), https://www.cbpp.org/sites/default/files/atoms/files/7-20-17tax.pdf [https://perma.cc/RB4K-9TZS] (showing the allocation of the corporate tax burden by a variety of estimators); JAMES R. NUNNS, URBAN-BROOKINGS TAX POLICY CTR., HOW TPC DISTRIBUTES THE CORPORATE INCOME TAX 18 tbl.8 (2012), https://www.taxpolicycenter.org/publications/how-tpc-distributes-corporate-income-tax [https://perma.cc/E83K-EHFM] (evaluating the evidence on the burden of the corporate income tax and concluding that rate reductions, as opposed to more direct incentives for investment, are particularly regressive with over 50% of the benefit going to the top 1%); *see also* Joel Slemrod, *Is This Tax Reform, or Just Confusion?*, 32 J. ECON. PERSPECTIVES 73, 90 (2018) ("[T]o assert that [corporate tax reductions] will largely benefit workers is, in my opinion, a stretch that the empirical literature does not substantiate.").

162. *See, e.g.*, WILLIAM GALE ET AL., URBAN-BROOKINGS TAX POLICY CTR., WINNERS AND LOSERS AFTER PAYING FOR THE TAX CUTS AND JOBS ACT 1–2 (Dec. 8, 2017), https://www.taxpolicycenter.org/publications/winners-and-losers-after-paying-tax-cuts-and-jobs-act/full [https://perma.cc/8J67-R2AG].

163. *Id.* at 1.

middle and the bottom will likely bear a disproportionate burden of the legislation's costs once these future deficit reduction measures are taken into account, while taxpayers at the top of the distribution will likely enjoy a significant net benefit.[164]

The discussion in Part IV returns to a variation of this question of future financing and explains how the 2017 legislation's structure will obstruct future efforts to finance its costs and generate additional revenue through future progressive taxes, thereby highlighting additional dimensions of Gale's finding. Before returning to the discussion of the 2017 tax legislation and its structural obstacles to progressive reforms, however, Part II and III first describe the theory of the progressivity ratchet in abstract terms.

II. NEUTRALITY AND TAX PREFERENCES

This Part describes well-known principles of efficient tax design in the public finance literature. It then builds upon these principles to discuss the case of tax preferences introduced in response to other preexisting preferences in the tax law. This discussion explains—by revisiting the neutrality principle—how a new tax preference introduced in response to an initial preference can either increase or decrease efficiency in the tax system, and emphasizes the first-order significance of the particular legal rules governing access to the preferences in determining the effect of a new preference (such as the corporate rate reduction or Section 199A). The discussion in this Part describes the harm, within an optimal tax framework, of introducing poorly targeted preferences. Part III then builds from this analysis to describe the how these effects can interact with political constraints to result in less progressive outcomes.

A. GENERAL PRINCIPLES

This Section first describes why, as a general matter, the tax system should treat close substitutes similarly in order to minimize costly tax avoidance. The following Sections then illustrate the challenges in applying this basic principle in the case of real-world tax rules that define the taxable base in different ways and that offer unique tax reduction opportunities.

164. *Id.* at 9–11, 15–16, 18–29 tbls. 1–12 (describing how the distributional effects of the House and Senate bills change under different possible financing scenarios).

The public finance literature offers a basic principle for tax design: raising taxes will generate greater tax avoidance—resulting in revenue loss and efficiency costs—to the degree taxpayers can escape tax increases by changing the form or substance of their activities.[165] This broad statement can be understood through three factors described below: (1) the amount of the change in a specific tax base resulting from a change in tax rates on that base, often referred to as the elasticity of the tax base; (2) the amount of revenue lost per unit of decline in the amount of the tax base as rates rise, which this Article refers to as the "tax rate differential"; and (3) the efficiency cost of raising additional taxes through a particular tax rule, often referred to in the literature as the "marginal efficiency cost of taxation."[166] In turn, these three concepts lead to the "neutrality principle" which provides that close substitutes for the same activities should be taxed more similarly than should activities which are not close substitutes.

Elasticity of the Tax Base. The elasticity of the tax base refers to the amount that the tax base changes resulting from a change in the tax rates on that base, as taxpayers respond to a rate change by changing the form or substance of their taxable activities.[167] In the case of the income tax, this measure is often called the "elasticity of taxable income."[168]

Elasticity of the tax base depends upon both "margins" in the tax law and "substitutes" for the taxable activity. A margin in the tax law distinguishes between different taxable activities, and potentially treats one activity less favorably than the other.[169] The term "substitute" in this context refers to an alternative to a taxable activity that a taxpayer may favor if the

165. *See, e.g.*, Emmanuel Saez et al., *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LIT. 3, 4 (2012) ("Taxes trigger a host of behavioral responses intended to minimize the burden on the individual. In the absence of externalities or other market failure, and putting aside income effects, all such responses are sources of inefficiency . . . .").

166. *See infra* note 180 and accompanying text.

167. *See* Saez et al., *supra* note 165, at 4.

168. *See id.* at 4 (describing elasticity of taxable income as a "worthy topic of investigation" for its ability to capture behavioral responses to taxation).

169. David Weisbach has referred to "margins" in the tax system as "lines" and the challenge of defining those margins or lines as the "line-drawing problem." *See* Weisbach, *supra* note 11, at 71.

cost of the taxable activity increases.[170] The elasticity of a tax base in turn measures the responsiveness of a taxpayer to higher taxes on one taxable activity, as they shift across a margin in the tax law to substitute into another activity not subject to the same tax increase.[171]

The elasticity of a given base therefore depends on the availability of substitutes that are treated more favorably and the sensitivity of taxpayers to changes in the relative costs of different activities. If a close substitute exists for a taxable activity, then that taxable activity will have a higher elasticity. If the taxable activity does not have a close substitute, then its elasticity will be lower.

To illustrate, consider the simple example of an economy with only two activities—*Activity A* and *Activity B*—and an income tax system that taxes the income from each. Assume that *Activity A* and *Activity B* both yield $10 million of income. Lawmakers then introduce a margin in the tax law that treats the two activities differently and raise the tax rate on *Activity A*—but not on *Activity B* (which is now preferentially taxed)—by 1%. The efficiency costs and revenue effects of this rate increase will depend, in part, on the degree to which *Activity B* is a close substitute for *Activity A*. If the tax increase on *Activity A* will induce taxpayers to substitute *Activity B* for *Activity A* to receive more favorable tax treatment—that is, if *Activity A* is relatively elastic—then the tax increase on *Activity A* will generate greater efficiency costs and raise less revenue.

For example, assume $500,000 of income from *Activity A* may shift to *Activity B* because of the 1% tax rate increase on *Activity A*. Calculating the resulting revenue loss and efficiency cost from that substitution then requires one additional piece of information: the magnitude of the tax rate differential between the two activities.

The Tax Rate Differential. The tax rate differential measures the magnitude of the difference in tax rates applied to two taxable activities.[172] That is, the tax rate differential

170. *See, e.g.*, *id.* at 77 ("Suppose cars are taxed but other methods of transportation are not. People will switch to close substitutes for cars, say, small trucks."); *see also* ROSEN & GAYER, *supra* note 10 and accompanying text.

171. *See, e.g.*, Saez et al., *supra* note 165, at 6 (defining elasticity of taxable income).

172. Saez et al. describe the role of this tax rate differential in analyzing

may be understood as measuring the magnitude of the margin separating the two activities. Returning to the example above, assume that, prior to the 1% tax increase on *Activity A*, the rules taxed *Activity A* at a 30% rate and *Activity B* at a 20% rate. This system therefore raised $5 million in total revenues: $3 million from taxing income from *Activity A*[173] and $2 million from taxing the income from *Activity B*.[174]

Policymakers can then calculate the additional revenue generated by the 1% increase in the tax rate on income from *Activity A* through two steps. The first step considers the revenue effect on a purely static basis, assuming no substitution to *Activity B*. In the example above, the static effect of the 1% increase would yield an additional $100,000 of revenue.[175] The second step calculates the revenue loss resulting from taxpayers responding to the higher tax on income from *Activity A* by substituting to *Activity B*. In the example above, the 1% increase on income from *Activity A* causes taxpayers to shift $500,000 of income from *Activity A* to *Activity B*.[176] This $500,000 of shifted income multiplied by the tax rate differential measures the amount of revenue loss from the shift. In this case, the differential equals 11%[177] and the total revenue loss from the shift equals $55,000.[178] As a result, the 1% tax increase on income from *Activity A* will yield $45,000 in net additional revenues.[179]

the effects of tax base shifting on revenue and social costs. *See id.* at 10–12. They frame the positive revenue generated from the alternative tax base which taxpayers shift to as a "fiscal externality." The key issue, as they define it, in assessing the effects of base shifting is the net revenue lost due to this fiscal externality. *Id.* We frame this same issue in terms of the tax rate differential—the differential between the tax rate on the initial base and on the base into which the income shifts.

173. 30% of the $10 million base of taxable income from *Activity A*.

174. 20% of the $10 million base of taxable income from *Activity B*.

175. 1% of the unchanged $10 million base of taxable income from *Activity A*.

176. That is, now taxpayers will earn only $9.5 million of income from *Activity A* and $10.5 million of income from *Activity B*.

177. The 31% rate on *Activity A* less the 20% rate on *Activity B*.

178. 11% of the $500,000 of shifted income that is now taxed at the lower 20% rate.

179. The $100,000 static revenue increase calculated in the first step less the $55,000 revenue loss from shifting into *Activity B* calculated in the second step. In this case, $9.5 million of income from *Activity A* is taxed at a 31% rate and $10.5 million of income from *Activity B* is taxed at a 20% rate, for total tax

The Marginal Efficiency Cost of Taxation. The revenue loss from substitution induced by higher tax rates—reflecting the combined effect of the elasticity of the tax bases and the tax rate differential—can approximate what the literature terms the "marginal efficiency cost of taxation."[180] This term measures the efficiency cost to individuals that results from raising a fixed amount of additional revenue from a particular tax base.[181]

To understand why revenue loss from substitution can approximate the efficiency costs from raising additional revenue, consider again the example above. In order to avoid a small tax rate increase of 1% on income from *Activity A*, taxpayers respond by shifting a portion of their income from *Activity A* to income from *Activity B*.

Prior to the tax increase, the tax rate differential between the two bases already equaled 10%, but a differential of this magnitude was insufficient to induce taxpayers to shift the $500,000 of income from *Activity A* to *Activity B*.[182] That is,

revenue of $5,045,000, or $45,000 more than the $5 million of revenue raised before the tax increase.

180. *See, e.g.*, Joel Slemrod, *Methodological Issues in Measuring and Interpreting Taxable Income Elasticities*, 51 NAT'L TAX J. 773, 777 (1998) ("[T]axpayers will undertake behavior that reduces tax liability up to the point that the marginal cost equals the marginal tax saving. In the real substitution case, the cost is an otherwise unattractive bundle of goods. With avoidance, the cost may be expenditures on professional assistance. With evasion, the cost may be exposure to the uncertainty of an audit and any attendant penalties for detected evasion."); Joel Slemrod & Shlomo Yitzhaki, *The Costs of Taxation and the Marginal Efficiency Cost of Funds*, 43 IMF STAFF PAPERS 172, 186 (1996) ("The critical question is how to evaluate, from a social point of view, the leaked dollars. . . . [A] rational taxpayer will be ready to sacrifice up to, but no more than, one dollar in order to save a dollar of taxes."). Importantly, the revenue loss only equals the efficiency cost under certain conditions which will not always hold true. One is that those avoiding the tax increase are not constrained "at a corner solution." An example of a "corner solution" is when a taxpayer fully shifts all income out of the tax base, in which case the effort put into that planning may be less than the amount of taxes saved. *Id.* at 186–87.

181. *See, e.g.*, Slemrod & Yitzhaki, *supra* note 180, at 185 (defining the marginal efficiency cost of funds "as the cost to the society of increasing tax revenue by a dollar, through a change in the tax rate or other fiscal instrument"). As used in this Article, "efficiency cost" refers to the resources expended by individual taxpayers to avoid taxation.

182. They might already have shifted other income in response to the tax rate differential, but they had not yet shifted the additional $500,000 in response to the subsequent tax increase.

even prior to the 1% rate increase, taxpayers could have saved $50,000 in taxes by shifting the $500,000 of income from *Activity A* to *Activity B*, but they didn't make this shift. Shifting to *Activity B* must have entailed additional effort or non-tax costs which exceeded the $50,000 tax savings to be gained. The additional 1% increase in the tax on income from *Activity A*, however, induces the taxpayers to make the shift. That is, the additional $5,000 tax savings from shifting the income to *Activity B* makes the shift worthwhile. Of the taxpayer's total $55,000 in savings from the shift, they must therefore experience a gain of no more than $5,000, while the government loses the full $55,000 in revenue. As a result, the net efficiency cost of the shift (measured as the difference between the revenue loss to the government and the benefit that the taxpayers enjoy from tax avoidance) is between $50,000 and $55,000.[183]

Policymakers can then compare this cost to the net revenue raised from the tax increase. In this case the net revenue gain of $45,000 entailed an efficiency cost of between $50,000 and $55,000. That is, each additional dollar of revenue raised from increasing the rate on *Activity A* resulted in slightly more than one dollar of efficiency cost.

Gaining additional revenue at a high efficiency cost may still be desirable from the policymaker's perspective. Whether to undertake the trade-off depends on the effect on overall social welfare. Specifically, it depends on the trade-off between the social value of the $45,000 in transfers, public goods, and services that will be financed by the additional revenue versus the social welfare loss from the $50,000 to $55,000 in efficiency cost to the taxpayer. That trade-off can partially depend on who receives the benefits from the revenue raised and who bears the efficiency cost of taxation. For instance, if the efficiency costs are borne by taxpayers at the top of the income distribution and the revenue benefits members of society at the bottom, that trade-off might still significantly enhance social welfare. One view in the literature argues that the efficiency costs at the top translate into little social welfare loss, because of the diminish-

183. If the taxpayers realize almost the full $5,000 benefit from the shift, then the net social costs will be the $55,000 revenue loss less the approximately $5,000 taxpayer benefit, or $50,000. If the taxpayers realize almost none of the benefit from the shift, then the net social cost will be the $55,000 revenue loss less the approximately $0 taxpayer benefit, or $55,000.

ing higher marginal utility of income and because society should place greater weight on the welfare of the least well off.[184] More broadly, however, in the presence of a higher marginal efficiency cost of taxation, these benefits from raising additional revenue entail greater efficiency cost than they would otherwise. Most views would agree that this scenario would be less desirable than an alternative scenario where policymakers can raise the same amount of revenue from the same taxpayers at a lower efficiency cost.

The marginal efficiency cost of taxation varies with a number of factors under policymakers' control. Policymakers might reduce the elasticity of the tax base by reducing margins or making it harder to shift across them.[185] They might also reduce the tax differential across the margins.[186] Policymakers

184. Empirical studies support for the notion that the marginal utility of income falls on average as income rises. *See, e.g.*, R. Layard et al., *The Marginal Utility of Income*, 92 J. PUB. ECON. 1846, 1857 (2008) (surveying evidence to conclude that the marginal utility of income declines on average faster than in proportion to the increase in income). *But see* Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904, 907–08 (2011) (agreeing that "some empirical evidence supports declining marginal utility," while describing how "other evidence also suggests that certain individuals actually experience increasing marginal utility, at least over some range of income"). This assumption of declining marginal utility is often adopted in optimal tax analysis. *See, e.g.*, Diamond & Saez, *supra* note 7, at 168–70 (assuming, for purposes of calculating the optimal top tax rate, that the "marginal social weight on consumption" is small for those at the top of the income distribution because of the declining marginal utility of income). The assumption of low social value from additional income at the top of the distribution can also derive from a combination of declining marginal utility of resources and simply putting less weight on the additional utility of those with the most resources as compared to those with less. *See, e.g.*, JOHN RAWLS, A THEORY OF JUSTICE 52–93 (rev. ed. 1999) (defining and justifying the "difference principle" under which "the higher expectations of those better situated are just if and only if they work as part of a scheme which improves the expectations of the least advantaged members of society").

185. *See* Slemrod, *supra* note 180, at 779 ("[T]he characterization of an optimal tax system must include not only the tax rate structure but myriad other instruments that subsume, but are not limited by, the definition of taxable income. The elasticity of taxable income will depend on the setting of these other instruments. It is not an immutable function of preferences." (emphasis omitted)); Joel Slemrod & Wojciech Kopczuk, *The Optimal Elasticity of Taxable Income*, 84 J. PUB. ECON. 91, 94 (2002) (describing the benefit of reducing the elasticity of taxable income and then deriving an "optimal elasticity" based on how a reduction trades off against other factors such as administrative costs).

186. *See, e.g.*, *infra* Part IV.D.2 (describing possible rule-based solutions to

could attempt to eliminate margins entirely and tax activity the same[187] but this approach could interfere with other normative goals such as fairness and administrative efficiency.[188] In a real-world tax system that contains margins, substitution across those margins, and tax differentials, the "neutrality principle" provides another way for policymakers to minimize the marginal efficiency cost of taxation.

The Neutrality Principle. The neutrality principle generally provides that close substitutes for the same activities should be taxed more neutrally—with smaller tax differentials—than should activities which are not close substitutes.[189] This rule derives from the marginal efficiency cost of taxation analysis described above, and how this cost depends upon both the elasticity of the taxable activities and the tax rate differential between them.[190] If two activities are close substitutes—and therefore a small rate differential induces a substantial shift from one activity to the other—policymakers should instead reduce the rate differential, even if that means increasing the rate differential with other activities that are not close substitutes.

Consider again the example of *Activity A* and *Activity B*, and now add a third, *Activity C*, which is taxed at a preferential rate.[191] Policymakers now must consider how to tax *Activity A* and *Activity B* in light of this low rate of tax on *Activity C*.

"break the ratchet" by discouraging shifting across margins and reducing tax differentials across margins).

187. *See infra* Part IV.D.2.

188. The only systems that would not have any margins across which taxpayers could substitute to reduce tax liability involve what are sometimes called "lump sum" taxes or "endowment taxes"—where the tax liability is determined by immutable characteristics. *See generally* Lawrence Zelenak, *Taxing Endowment*, 55 DUKE L.J. 1145, 1148 (2006) (considering the merits of endowment taxes). For a deeper exploration of some of the trade-offs in reducing elasticity, see Slemrod & Kopczuk, *supra* note 185. For a discussion of corporation integration methods, which could at least reduce—even if not eliminate—the margins in the taxation of business income, see *infra* notes 313–19 and accompanying text.

189. *See supra* notes 10–11 and accompanying text.

190. *See supra* notes 185–88 and accompanying text.

191. Assume that policymakers cannot or choose not to change this rate. For example, this scenario could represent the case of Congress responding to low taxed foreign income with a corporate rate cut, or responding to the corporate rate cut with Section 199A.

Assume, in the extreme cases, that *Activity A* is a close substitute for *Activity C*, but *Activity B* is not. In this case, *Activity A* should be taxed at a rate close to that for *Activity C* while *Activity B* could potentially be taxed at a significantly higher rate than both *Activity A* and *Activity C*. The reason for this is that policymakers cannot gain much revenue from taxing *Activity A* more than *Activity C* and any revenue gained from higher taxes on *Activity A* will entail a higher efficiency cost. Policymakers can tax *Activity B*, by contrast, at a higher rate, since it is not a substitute for *Activity A* or *Activity C*. On the other hand, if *Activity A* and *Activity B* are close substitutes for each other but not for *Activity C*, then policymakers should tax *Activity A* and *Activity B* more neutrally, and should not necessarily align the tax rate with the rate on *Activity C*. These variations illustrate the basic point that the relative taxation of the different activities—and the desirability for greater neutrality among them—depends on the degree to which the activities are close substitutes.[192]

B. THE VARYING EFFECT OF NEW TAX PREFERENCES

The neutrality framework can help explain the likely effect of the new business tax preferences in the 2017 legislation. This Section develops an analytical framework for evaluating how a new preference interacts with preexisting preferences in the tax rules. In theory, the introduction of a new preference in this context can, in fact, be consistent with the neutrality principle—and thus decrease the efficiency cost of funds and increase the revenue that can be raised at any given set of rates. This desirable result, however, requires careful targeting of the new preference in a way that may practically be difficult to achieve through the drafting of tax rules. At the same time, the introduction of a mistargeted preference can compound the effect of the preexisting preference and result in even greater efficiency costs, and lower revenue raised, from the chosen tax rates.

192. *See also* Weisbach, *supra* note 11, at 77 (using a similar example of an initial distortionary tax on cars then justifying a second distortionary tax on trucks since they are close substitutes, where the addition of the second distortionary tax on trucks reduces distortions on net).

1. Multiple Preferences and Targeting

The neutrality framework suggests that if the tax rules already contain a preference for some sector of the base that cannot be eliminated, then additional preferences may help mitigate the efficiency costs and revenue loss resulting from the first preference. Two (or more) preferences could be better than one if the additional preferences result in close substitutes being treated more neutrally than are non-substitutes.

Critically, that correct application of the neutrality framework requires evaluation of the legal rules defining the various preferences and exactly what activities they target. To properly apply the neutrality principle, policymakers must distinguish between preferences that improve the neutrality of the tax system (and in fact treat close substitutes more similarly) and preferences that expand the scope of the preferences to other portions of the tax base and therefore compound the efficiency costs and revenue loss. The mistargeting may result from the poor design of tax rules or the innate challenges of effectively defining and preferencing particular activities without preferencing others as well. In the case of such mistargeting, two (or more) preferences can be worse than just one.

A new tax preference can help mitigate the effect of another preference if: (1) the new preferential rate properly targets activity that would otherwise shift over to another low-taxed activity and (2) the new preferential rate is still set higher than the rate on the other low taxed activity. Under those circumstances, a new preference effectively reduces the efficiency costs and revenue loss from the first preferenced activity. The opposite occurs, however, if the new preference doesn't meet those criteria, and is either poorly targeted to substitutable activity or offers an even larger tax benefit than one for the first preferenced activity. In this case, the second preference will result in even higher efficiency costs and lower revenue raised from tax increases on the remainder of the tax base.

To illustrate the different effects of properly targeted and mistargeted preferences, and how the additional preference can either mitigate or compound the efficiency costs and revenue loss from the initial preference, consider again the case of *Activity A* and *Activity B*. Assume again that income from *Activity B* is taxed at a fixed 20% and cannot be increased. As illustrated in Part II.A., this preference reduces the revenue-raising po-

tential and increases the efficiency costs from a tax increase on income from *Activity A*.

If policymakers cannot eliminate the preference for *Activity B*, they may be able to mitigate its effect by introducing a new preference for some subset of the taxpayers engaged in *Activity A* who could in fact shift to *Activity B* at a relatively low cost. In the example above, $500,000 of income shifts from *Activity A* to *Activity B* when the tax rate on income from *Activity A* increases by 1% from 30% to 31%. Now, imagine that policymakers had perfect information and knew exactly which taxpayers would make the switch to *Activity B* when the tax rate on income from *Activity A* increases from 30% to 31%. The policymakers could then exempt those taxpayers from the tax rate increase (call them the "*Activity A 30% Cohort*"). In this case, raising the tax by 1% on the remainder of the income from *Activity A* produces no substitution at all—and therefore no efficiency costs—and generates $95,000 in additional revenue,[193] far more than in the example above of an across-the-board rate increase for all income from *Activity A*. In this case, the second preference mitigates the effect of the progressivity ratchet resulting from the initial preference. The new preference for the *Activity A 30% Cohort* could in fact justify even *higher* rates on the remaining income from *Activity A* than would otherwise be the case.[194] This higher rate could consequently generate even more revenue to finance government spending at a relatively low efficiency cost.

In an ideal setting with perfect information and no administrative challenges, policymakers could develop a series of highly targeted preferences that minimize costly substitution responses by taxpayers. For example, even the 30% rate on income from *Activity A* may induce some substitution to *Activity B*, which might be discouraged by lowering the rate on income from *Activity A* to 29%. Policymakers could design a second targeted preference to eliminate this shifting as well, by preferencing an "*Activity A 29% Cohort*." Policymakers could make the same adjustments to target tax preferences to any subset of

193. The 1% additional tax on the remaining $9.5 million of income from *Activity A* that is not attributable to *Activity A 30% Cohort*.

194. Policymakers could raise the rates on the remaining income from *Activity A* up to the point that the higher rates induce further substitution to *Activity B* or other behavioral responses.

taxpayers or activities who would otherwise switch their activity at each rate level, thus minimizing the inefficient substitution from high-taxed *Activity A* to low-taxed *Activity B*.

This policy response simply illustrates the neutrality principle, that policymakers should reduce the tax rate differential on close substitutes. In the real-world, however, policymakers do not have the information necessary to perfectly target tax preferences. Policymakers may also be constrained by the innate challenges of writing tax rules that narrowly define specific taxpayers and economic activities. Imprecise targeting of tax preferences, however, can have the adverse consequence of compounding, rather than mitigating, the effects of an initial preference.[195] First, a poorly targeted preference can provide a windfall to some taxpayers who would not have shifted their activity. This lost revenue would necessitate lower government spending or higher taxes at other points in the system. Second, the poorly targeted preference could provide a new opportunity for substitution that never existed before. Both of these effects can raise the marginal efficiency cost of taxation on the remainder of the base and reduce the revenue raising potential from higher rates.[196] This is because higher taxes would be focused on a smaller base which may still be subject to the same avoidance as before while the new preference offers taxpayers an additional opportunity to avoid the top rate.[197]

Consider again the case of *Activity A* and *Activity B*, with $10 million of income earned from each. Assume that policymakers attempt to mitigate the effects of a preference for income from *Activity B* by creating a new category of tax, called "*Activity A Preferred*" which is taxed at a 25% rate. Policymakers draft complex rules to differentiate between *Activity A* and *Activity A Preferred*, attempting to target those taxpayers most

195. *See supra* note 15 and accompanying text.

196. *See supra* note 180 and accompanying text.

197. This example illustrates how the 1% rate increase on the residual base will end up raising less revenue and at a greater efficiency cost than before. The efficiency cost is amplified if the revenue loss from the "windfall" tax cut is recovered through other tax rate increases which would generate yet more substitution. The revenue loss and welfare cost associated with a given change in the tax rate would rise further as rates increase. In other words, the next percentage point tax increase would tend to cause even more substitution than the last one, as under certain conditions the distortion generated by tax rate differentials is proportional to the square of the rate differential. *See* ROSEN & GAYER, *supra* note 10, at 554.

likely to shift from *Activity A* to *Activity B* as a result of a further increase in the tax rate. Have the policymakers mitigated the negative effects of the preference for *Activity B* by creating a situation where higher taxes on income from *Activity A* would raise more revenue at a lower efficiency cost? This depends whether the policymakers effectively targeted the new preference.

First, consider the case of complete mistargeting. In this situation, the preference would provide a windfall to any taxpayers who automatically qualify for *Activity A Preferred* even though they would not have substituted toward *Activity B* in response to a 1% rate increase on income from *Activity A*. Assume that the windfall encompasses one-fourth, or $2.5 million, of the *Activity A* tax base, leaving a residual base of $7.5 million in *Activity A* who do not automatically qualify for the new preference.

The 1% tax rate increase on income from *Activity A* would then, before taking into account any additional substitution, apply to this smaller residual base. If no further substitution occurred, this 1% increase would raise $75,000 in additional revenue. Because of the complete mistargeting, however, the same $500,000 in income would still substitute from *Activity A* to *Activity B*, reducing revenue by $55,000.[198] Also assume that, due to the mistargeting, an additional $200,000 of income now shifts from *Activity A* to *Activity A Preferred*, reducing revenue by an additional $12,000,[199] leaving a tax base of only $6.8 million in *Activity A*. Altogether, the substitution reduces revenue by $67,000, and the net revenue raised falls to $8,000.[200] The tax increase raises relatively little revenue at a relatively high

198. The $500,000 that shifts from *Activity A* to *Activity B* multiplied by the tax rate differential on these bases of 11%.

199. The $200,000 that shifts from *Activity A* to *Activity A Preferred* multiplied by the tax rate differential on these bases of 6%.

200. Before the 1% increase on income from *Activity A*, this package of rates would tax $7.5 million of income from *Activity A* at 30%, $2.5 million of income from *Activity A Preferred* at 25%, and $10 million of income from *Activity B* at 20%, for total revenue raised of $4,875,000. After the 1% increase induces additional shifting from *Activity A*, the package of rates would tax $6.8 million of income from *Activity A* at 31%, $2.7 million of income from *Activity A Preferred* at 25%, and $10.5 million of income from *Activity B* at 20%, for total revenue raised of $4,883,000, or only $8000 more than before the 1% rate increase.

efficiency cost.[201] In this case, the poorly targeted preference substantially compounds—rather than mitigates—the effect of the initial preference for *Activity B*.

By contrast, assume the policymakers more accurately—though still imperfectly—target *Activity A Preferred* to the desired group of taxpayers. In this case, *Activity A Preferred* primarily benefits the taxpayers who would otherwise shift from *Activity A* to *Activity B* if the rate of tax on income from *Activity A* increases. Assume that *Activity A Preferred* automatically preferences only $500,000 of income from *Activity A*, leaving $9.5 million in the residual *Activity A* base. Further, assume that most of that $500,000 would otherwise have shifted from *Activity A* to *Activity B* if the rate on income from *Activity A* increased further. In this case, a 1% tax increase on this residual in *Activity A*, before accounting for further shifting, would raise $95,000 of revenue. Assume that, because the preference is more accurately targeted, the 1% tax increase on income from *Activity A* only results in a shift of $100,000 of income from the residual *Activity A* to *Activity B*, and only $50,000 from *Activity A to Activity A Preferred*. The revenue loss from the substitution would now only be $14,000,[202] and the net revenue raised from the tax rate changes would increase to $81,000.[203]

In this case, the addition of *Activity A Preferred* mitigated the adverse effects of the *Activity B* tax preference. Additional revenue can now be raised from *Activity A* at a lower efficiency

201. In this case, the efficiency cost to the taxpayer from the additional substitution would be between $60,000 and $67,000. This reflects the fact that taxpayers substituting chose not to make the switch to *Activity A* and *Activity A Preferred* at the previous tax differentials of 10% and 5% respectively—meaning that there must have been transaction costs that outweighed the tax benefits at the previous differentials.

202. The $100,000 that shifts from *Activity A* to *Activity B* times the tax rate differential on these bases of 11%, plus the $50,000 that shifts from *Activity A* to *Activity A Preferred*, times the tax rate differential on these bases of 6%.

203. In this case, before the 1% increase on income *Activity A*, this package of rates would tax $9.5 million of income from *Activity A* at 30%, $500,000 of income from *Activity A Preferred* at 25%, and $10 million of income from *Activity B* at 20%, for total revenue raised of $4,975,000. After the 1% increase induces a minimal degree of additional shifting from *Activity A*, the package of rates would tax $9,350,000 of income from *Activity A* at 31%, $550,000 of income from *Activity A Preferred* at 25%, and $10.1 million of income from *Activity B* at 20%, for total revenue raised of $5,056,000, or $81,000 more than before the 1% rate increase.

cost than was possible before the introduction of the preference.[204]

These examples illustrate how a new preference can either mitigate or compound the negative effects from an initial preference—the higher efficiency cost and less revenue raised from taxes on other portions of the tax base. This varying effect of a new preference depends on the legal rules defining the preference, and whether it is effectively targeted to the activities that would have otherwise shifted into the previously preferenced activity.

2. Multiple Preferences with a Choice in Tax Systems

This framework for evaluating when a new preference introduced in response to an initial preference compounds or mitigates the effects of an initial preference may be expanded to consider the case of a choice in tax systems. Applying the framework in this scenario also helps explain why it is a mistake to pursue average rate neutrality across the corporate and pass-through systems, as is sometimes suggested.[205] In fact, this mistaken pursuit can increase the efficiency costs of raising revenue in *both* systems for the same reason that poorly targeted new preferences would have this effect in the general case described in the preceding Section.

By "choice in tax systems," this Article refers to the ability of taxpayers to select different methods for measuring and taxing the same activities. There may be independent reasons why the tax rules should allow a choice of tax systems in certain cases. Taxing some taxpayers and their activities in one system and others in another may provide administrative and compliance benefits to both taxpayers and the government. For example, as described above, the corporate tax system is often justified as a more administrable method of taxing large entities with many owners and frequent changes in ownership.[206] Offering taxpayers and entities a choice between tax systems may be

204. The social cost would be between $12,500 and $14,000, again reflecting the fact that the revenue-losing substitution was not undertaken at the prior rate differentials.

205. *See, e.g.*, Holtz-Eakin Testimony, *supra* note 116; 2012 JOINT REPORT, *supra* note 118, at 7.

206. *See supra* note 33 and accompanying text.

desirable if it allows them to select into the most administratively efficient systems for their circumstances.

If policymakers decide to preserve a choice in tax system, they must then determine how rates in the two systems should relate. One approach would be to closely align the tax rates in the two systems for each individual taxpayer and activity, so that the choice between systems doesn't generate opportunities for tax-reducing substitution. This approach might not be feasible, however, if the administrative benefits from preserving separate systems require differential tax treatment of at least some activities.[207] If policymakers must accept differential tax treatment of some activities across the two systems, they must then determine how to the optimize tax rates across the systems. The neutrality principle described above applies here as well: treat close substitutes more similarly, as compared to activities that are not close substitutes. The neutrality principle does not suggest, however, that policymakers should equalize average rates across the two systems. This approach can in fact violate the neutrality principle and compound the revenue loss and efficiency costs resulting from taxpayer's substitution responses.

For example, consider the scenario in Table 1 below, with two activities, *Activity A* and *Activity B*, which can each be taxed under *System 1* or *System 2*. *System 1* and *System 2* both tax *Activity A* at the same 30% rate. *System 1* also taxes *Activity B* at a 30% rate, but *System 2* taxes *Activity B* at a preferenced 20% rate.[208] To improve neutrality between the two systems, policymakers then consider introducing a new preference in *System 1*: a lower 25% rate on income from "*Activity A Preferred*" which is a subset of *Activity A*.

207. Part IV.D.2 revisits this option of aligning tax rates for activities and taxpayers across the two systems by considering proposals to "integrate" the pass-through and corporate systems. This approach could align tax rates while retaining some of the administrative benefits from having two systems. *See infra* notes 312–18 and accompanying text.

208. Assume, for example, that the administrative advantages of a separate *System 2* also necessitate a lower tax on *Activity B* in *System 2*. One real-world example of such a preference could be the corporate system's deferral opportunities, which may allow taxpayers to reduce or eliminate the second individual layer of tax.

Table 1: Illustration of a Choice in Tax Systems		
	System 1	System 2
Activity A	30%	30%
Activity B	30%	20%
Reform Option: "Activity A Preferred" in System 1	25%	30%

The introduction of the preference for *Activity A Preferred* may achieve greater *average* rate neutrality between the two systems.[209] This fact, however, is immaterial for purposes of properly applying the neutrality principle. The analysis of whether the introduction of the preference for *Activity A Preferred* follows the same structure as the analysis of any new preference introduced in response to an initial preference, as described in the preceding Section.

Properly applying the neutrality principle in this case similarly requires evaluating whether *Activity A Preferred* effectively targets activity that would otherwise substitute from *Activity A* (in either *System 1* or *2*) to *Activity B* in *System 2*. If *Activity A Preferred* effectively targets income likely to shift, then the lower tax rate on *Activity A Preferred* would help mitigate the efficiency costs and revenue losses that the preference for *Activity B* in *System 2* generates on the top tax rates in both systems. If, however, *Activity A Preferred* does not effectively target income likely to shift, it will instead increase the tax reduction opportunities for income in both systems and worsen

209. Assuming *Activity A* and *Activity B* each produce equal amounts of income under each system prior to the reform, then the average rate under *System 1* would be 30% while the average rate under *System 2* would be 25%. After the introduction of the preference for *Activity A Preferred* in *System 1*, the average rate in this system would be lower than 30% and closer to the average rate in *System 2*.

the efficiency costs and revenue losses resulting from the preference for *Activity B* in *System 2*.

This example illustrates how a new preference that may bring average tax rates across two tax systems closer together could either compound or mitigate the effects of an initial preference. Stated differently, the end result might be something closer to average rate neutrality across the systems but a greater tax differential between close substitutes, which is what matters. Thus, pursuing average tax rate neutrality across choice-in-tax systems could violate—rather than follow—the neutrality principle. Policymakers should instead evaluate whether a new preference effectively targets income that would otherwise shift toward preferenced activity in either system.

C. DOES NEUTRALITY MATTER?

The analysis so far has expanded on the traditional neutrality principle in the public finance literature to explain how the introduction of a preference in response to another preference might either mitigate or compound the inefficiency costs and revenue loss generated by the first preference. As explained in Part IV, the new business tax preferences in the 2017 legislation constitute violations of the neutrality principle, as it should be properly understood.

However, this traditional optimal tax analysis does not fully capture the likely harm that results from mistargeted preferences of this kind. Raising a given amount of revenue at greater efficiency cost is less desirable under most views, if there is an alternative option to raise the same amount of revenue at a lower efficiency cost. In this case, the efficiency cost is simply wasted resources.

The degree of social concern with these efficiency costs may vary, however, depending on who bears these costs. If the additional efficiency costs are borne only by the wealthiest taxpayers, then these costs may not constitute a significant social welfare loss. In fact, some methods of aggregating social welfare would suggest that this doesn't matter much at all to society at large, if taxpayers at the top derive less utility from additional resources.[210] Frameworks like this would suggest that the

210. *See supra* note 184 and accompanying text.

wealthiest taxpayers are already significantly under-taxed. Raising the same amount of revenue from these taxpayers in a less efficient fashion might not be a beneficial policy reform, but it would not have a significant negative effect on aggregate social welfare.

As the next Part explains, however, the harm from higher efficiency costs from taxing the wealthy could increase if policymakers face other constraints in increasing the progressivity of the tax system to offset revenue loss from poorly targeted preferences. Part III connects the optimal tax analysis to an analysis grounded in political economy, and the real-world constraints on enacting tax policy. This discussion explains how, by increasing the efficiency cost of additional revenue, mistargeted preferences benefiting the wealthiest taxpayers could lead to less revenue collected from the top, resulting in a progressivity ratchet that constrains the progressive potential of the tax system overall.

III. THE PROGRESSIVITY RATCHET

This Part builds upon the basic principles from the public finance literature laid out in Part II—and their extension to the case of a new preference introduced in response to an initial preference. It describes how a violation of the "neutrality principle" might lead to the political decision to generate less revenue from the highest income taxpayers, and therefore to accept a less progressive income tax system. In this respect, the progressivity ratchet results from an interaction of the effects of tax avoidance and the preferences of lawmakers and their constituents. Specifically, this Part describes three political constraints that, in combination with tax preferences allowing greater opportunities for tax avoidance, can generate the progressivity ratchet.

The progressivity ratchet suggests a harm from preferences that increase tax avoidance opportunities beyond those described in the traditional optimal tax literature. According to this literature, preferences that violate the neutrality principle will result in lower revenue raised, at a higher efficiency cost, from tax increases on other portions of the tax base.[211] This general harm—which is central in an optimal income tax anal-

211. *See supra* notes 165–92 and accompanying text.

ysis—is not this Article's central concern. Rather, the concern underlying the progressivity ratchet is as follows: if the preferences creating new opportunities for tax avoidance are maintained, policymakers may then choose over time to raise less revenue from the highest income taxpayers because of the political constraints described in this Part.

In the absence of these constraints, violating the neutrality principle and increasing tax planning might not have this adverse effect on progressivity. Policymakers might simply choose to increase tax rates on the highest income taxpayers to offset the revenue loss from increased tax avoidance, irrespective of the efficiency costs to those taxpayers. The discussion that follows describes, however, how the progressivity ratchet will arise in the presence of the three constraints, and suggests why they may be plausible factors resulting in a political choice to have a less progressive tax system, with less revenue raised from the top and less resources then available to the rest. This discussion also explains how the progressivity ratchet can operate in the reverse fashion in the presence of these constraints: higher taxes on a portion of the tax base can enable more revenue to be raised overall considering the effects on the remainder of the tax base.

A. THE THREE CONSTRAINTS

1. The Efficiency Cost Constraint

The first condition, the "efficiency cost constraint," follows directly from the marginal efficiency cost of taxation analysis described above. In an optimal tax model, a higher marginal efficiency cost of taxation implies a lower optimal tax rate on a given base, and a lower amount of revenue that should be raised and then spent on the uses of tax revenues: public goods, services, and redistribution.[212] This conclusion results from a simple logic: when certain taxes generate higher efficiency costs to certain taxpayers, raising these taxes—and thereby funding the government programs that they finance[213]—entails a high-

212. *See, e.g.*, Slemrod, *supra* note 180, at 776–80 (describing the relationship among the marginal efficiency cost of funds, the elasticity of taxable income, and the optimal amount of redistribution and purchase of public goods).

213. Assuming, of course, that the government cannot finance the programs through other taxes or debt financing on a permanent basis. That is,

er price paid in the form of greater efficiency costs. This was the dynamic explained in Part II. Thus, a higher marginal efficiency cost suggests policymakers should choose to raise less revenue than they would otherwise in order to limit spending to areas generating higher social benefits that justify the higher cost of raising revenue.

Policymakers do not strictly operate in an optimal tax model. If they did, the tax system would surely look very different than it does now, and the business tax preferences would not exist in the first place.[214] Nonetheless, policymakers may still be sensitive to the efficiency loss from raising additional revenue in some circumstances. Specifically, they may in some ways weigh the amount of harm imposed on certain constituents—like certain well-to-do constituents—relative to the revenue raised which can be used for public spending and redistribution.

Returning to the example above,[215] it may be that, from a policymaker's perspective, a 1% increase on income from *Activity A* is not "worth it" given the efficiency cost resulting from the additional revenue raised. The welfare gain from an additional $45,000 in public goods, government services, or redistribution funded by the tax may not justify the approximately $50,000 to $55,000 in efficiency costs imposed on the taxpayers—who may object to not just the $45,000 in additional taxes they pay, but also the $50,000 to $55,000 in efficiency costs they incur.[216]

Policymakers are likely sensitive to the efficiency costs of taxation, particularly in the case of high efficiency costs. Efficiency is generally considered a basic principle of tax policy design,[217] and concerns of efficiency may affect policy outcomes even when policymakers are not wholly committed to an opti-

this simple presentation holds constant the availability to generate revenue from other sources.

214. *See infra* Part IV (describing the problems with the new business preferences from an optimal tax perspective).

215. *See supra* notes 181–88 and accompanying text.

216. That is, from the government's perspective, the tax raises $45,000 in additional revenue, but from the taxpayer's perspective it imposes up to $100,000 of total costs. Of course, these same taxpayers may similarly object to a perfectly efficient tax that imposes a cost on them that is exactly equal to the amount of revenue raised.

217. For a formative articulation of the centrality of efficiency to tax policy analysis, see ARTHUR M. OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADEOFF (2015).

mal income tax framework.[218] Academic research suggests that policymakers are also likely to be more responsive to the preferences of the wealthy.[219] In this case, policymakers may tend to overweight the concerns of wealthy taxpayers who bear efficiency costs from taxation, even if the tax would otherwise be warranted because the welfare gains from the revenue raised (and spent or redistributed) would justify these efficiency costs to the wealthy. In fact, this research suggests a concern that policymakers may be overly responsive to these effects at the top of the income distribution, and not sensitive enough to the benefits that others members of society may receive as a result of the additional tax revenue raised.[220]

218. Professor James Poterba has argued, for example, that efficiency analysis plays an independent role in the political economy of tax policymaking. *See* James M. Poterba, *Public Finance and Public Choice*, 51 NAT'L TAX J. 391, 395 (1998) (arguing that, even in the political arena where outcomes depend on "equating the marginal political costs" of different policies, "efficiency-based tax policy analyses can provide a crucial input to the policy process by identifying aspects of the current or prospective tax code that impose substantial efficiency costs"); *cf.* Neil. H. Buchanan, *The Role of Economics in Tax Scholarship*, *in* BEYOND ECONOMIC EFFICIENCY IN UNITED STATES TAX LAW 11, 22 (David A. Brennan et al., eds., 2013) (arguing that acknowledging the limitations of "efficiency analysis" in tax policy "still leaves plenty of room for the use of 'economic tools' to assess policies").

219. *See, e.g.*, MARTIN GILENS, AFFLUENCE & INFLUENCE: ECONOMIC INEQUALITY AND POLITICAL POWER IN AMERICA 70–97 (2012) (describing the increased responsiveness of government policy to the preferences of high income members of society); KAY LEHMAN SCHOLZMAN ET AL., THE UNHEAVENLY CHORUS: UNEQUAL POLITICAL VOICE AND THE BROKEN PROMISE OF AMERICAN DEMOCRACY (2012) (describing the correlation between "political voice" and policy outputs); Daniel P. Tokaji, *Vote Dissociation*, 127 YALE. L.J.F. 761, 772 (2018) (describing academic research finding "that well-financed interest groups exercise outsized influence on public policy").

220. A possible alternative to this theory could justify maintaining preferences that increase the marginal efficiency cost of funds as a way to facilitate progressive outcomes. *Cf.* Stanley L. Winer & Walter Hettich, *What Is Missed if We Leave Out Collective Choice in the Analysis of Taxation?*, 51 NAT'L TAX J. 373, 384 (1998) ("In a competitive political system, governments create special provisions as a way of taking differing economic and political responses to taxation into account, while economizing on administration costs. This suggests that those special provisions that were introduced to make the tax system administratively or politically more efficient should be preserved rather than eliminated."). Specifically, it is possible that taxpayers benefitting from the preferences are particularly politically powerful subgroup. As a result, eliminating the preferences and including these taxpayers in a base subject to potential tax increases might reduce the chance of such tax increases succeeding, even if the tax increases would now be more efficient than they would other-

In the presence of this constraint, new preferences for business income can make higher progressive rates on individual income more costly from the perspective of policymakers, because the new preferences would induce taxpayers to incur further costs in order to change their behavior and access preferential treatment.[221] The preference for one portion of the tax base would thus constrain policymakers' ability to increase marginal rates—and thereby the degree of progressivity—on other portions of the tax base.

2. The Salience of Tax Rates Constraint

The second condition, "the salience of tax rates constraint," does not depend on a concern by policymakers or their constituents with the efficiency costs of taxation. This constraint depends instead on policymakers' sensitivity to the "sticker price" of the top marginal rates, whether reflecting their own preferences or those of their constituents. In this scenario, policymakers may be unable to simply increase tax rates on portions of the base in order to offset the revenue loss from preferential rates and the tax avoidance they generate.

This constraint is related to the "efficiency cost constraint," because it also describes a scenario where policymakers encounter a political cost to raising tax rates. Under the salience of tax rate constraint, however, policymakers may be unable to raise the rates even if there is little efficiency cost associated with a further tax rate increase. Rather, this constraint results from the unique political salience of the top statutory tax rates,

wise be with the preference. In this scenario the net efficiency cost to taxpayers subject to tax would be lower, but political difficulty could be greater. Different subgroups of the wealthiest taxpayers may have greater or lesser political influence on tax policy, as reflected by the fact that in many cases some wealthy taxpayers receive unique tax preferences that others do not. This possibility does not suggest, however, that the power among the rich is so fragmented that an inefficient preference for some subgroup of the wealthy will lead to more revenue raised from the rich as a whole, and an overall more progressive tax system. Policymakers will be faced with the fact that raising that revenue entails greater efficiency burden on at least some of the rich. Further, policymakers face additional constraints—such as "the salience of tax rates constraint" discussed in the following Section—that increase the likelihood that such inefficient preferences lead to less overall progressivity, rather than more.

221. *See infra* Parts IV.A–B.

and the limitations policymakers may face in raising more revenue by increasing these rates.

Evidence suggests that policymakers may perceive higher costs to increasing the progressivity of the tax system by raising the statutory tax rates, instead of through other changes to the tax rules. For example, Professor Deborah Schenk has argued that policymakers may not be able to raise revenue by increasing top marginal rates directly, because this salient method of increasing taxes would face greater obstacles from interest groups, institutional barriers in Congress, and the rhetoric of anti-tax objectors.[222] In this case, Professor Schenk argues, policymakers may be justified if they instead pursue lower-salience taxes as a "second-best" solution.[223]

For one example of the "stickiness" of the top marginal tax rates, consider the recent history of the top marginal rate on individual ordinary income. Before the changes in the 2017 legislation, ordinary income was taxed at top rate of 39.6%, which was the highest statutory tax rate on ordinary income in any year since 1986.[224] Congress first raised the rate to that level in the 1993 budget bill.[225] In 2001, Congress scheduled the rate to phase down to 35%,[226] then restored the same 39.6% rate in 2013,[227] and then cut the rate again to the current 37% in the 2017 tax legislation.[228] The 39.6% rate is of course somewhat arbitrary and originated in the particular way that the Clinton administration framed its 1993 tax rate increase which was no

222. Deborah H. Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 YALE J. REG. 253, 299–310 (2011). For a review of empirical work on the political salience of different forms of taxation, see David Gamage & Darien Shanske, *Three Essays On Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19, 33–54 (2011).

223. Schenk, *supra* note 222, at 310 ("[T]here are situations where [low-salience tax provisions] may enable the government to achieve otherwise worthy goals. So long as the process is reasonably transparent . . . there is no convincing argument that it would be wrong for the government to . . . [use] politically pleasing taxes or provisions.").

224. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13202, 107 Stat. 312.

225. *Id.*

226. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101, 115 Stat. 38, 42.

227. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101, 126 Stat. 2313, 2316 (2013).

228. *The 2017 Tax Legislation*, *supra* note 1, § 11001 (codified at I.R.C. § 199A (2017)).

longer relevant in 2013 when this same rate was restored.[229] Nonetheless, the 39.6% rate has continued to be a focal point of political discussion over tax reform.[230]

Similarly, during an earlier round of tax increases in 1990, Congress had to seek other ways to increase progressivity rather than by simply raising the statutory rate. President George H.W. Bush agreed to raise revenues as part of a bipartisan deficit reduction deal, but, to the degree possible, did not want to do so through an explicit statutory rate increase, because of his campaign pledge not to raise tax rates.[231] The solution was limiting the deductibility of itemized deductions for high income taxpayers, which effectively functioned as a marginal rate increase even if it wasn't written as such in the law.[232] The author of the provision in Congress explicitly described this solution "as a face-saving way for the President to raise taxes without technically raising the tax rates."[233] Of course, if Congress had many available ways to continue to

229. In 1993, President Clinton proposed two new higher ordinary income tax brackets—a 36% rate and a 39.6% rate. The 39.6% rate was framed specifically as a 10% surcharge on the highest incomes (10% x 36% + 36% = 39.6%). *See* Ruth Marcus & Ann Devroy, *Asking American To 'Face Facts,' Clinton Presents Plan To Raise Taxes, Cut Deficit*, WASH. POST (Feb. 18, 1993), https://www.washingtonpost.com/wp-srv/politics/special/states/stories/sou021893.htm [https://perma.cc/J5PY-5LD7]. That framing had fallen away by 2013. The 2013 law did not even restore the 36% bracket; instead, the second highest bracket was 35%. The 39.6% rate had taken on a separate logic of its own and the focal point as President Obama sought to repeal elements of the tax cuts in the 2000s.

230. For example, the infrastructure plan released by Senate Democrats in March, 2018 called for restoring the top marginal rate to exactly the same 39.6% in effect before the 2017 legislation. SENATE DEMOCRATS, JOBS & INFRASTRUCTURE PLAN FOR AMERICA'S WORKERS: RETURNING THE REPUBLICAN TAX GIVEAWAYS FOR THE WEALTHY TO THE AMERICAN PEOPLE (March 7, 2018), https://www.democrats.senate.gov/imo/media/doc/Senate%20Democrats'%20Jobs%20and%20Infrastructure%20Plan.pdf [https://perma.cc/N33S-NQ4R].

231. *See* Nathaniel C. Nash, *Deducting from Deductions of the Wealthier Taxpayers*, N.Y. TIMES (Oct. 23, 1990), https://www.nytimes.com/1990/10/23/us/the-budget-battle-deducting-from-deductions-of-the-wealthier-taxpayers.html.

232. *See* Schenk, *supra* note 222, at 277–78 ("[The itemized deduction limitation] is exactly the same as if Congress had raised the rate one percentage point. That of course would have been much simpler, but at the time it was also politically difficult to do.").

233. Nash, *supra* note 231.

raise rates without explicitly doing so in the tax rate tables, the "salience of tax rates" constraint may not significantly constrain progressive reforms, but such mechanisms are in limited supply. More importantly, the episode from 1990 again helps illustrate the particular political salience of statutory tax rates, and why policymakers may be more successful in adjusting tax burdens through other changes to the tax Code.

This constraint relates to the progressivity ratchet as follows. For any chosen top statutory rate on a portion of the tax base, preferences on other portions of the tax base that increase opportunities for taxpayers to avoid the top marginal rate will result in less revenue raised from that top rate. Of course, the preference for a portion of the base will reduce revenue, by explicitly reducing the amount of the base subject to the top rate. This effect is magnified, however, as economic activity subject to the residual high-tax base shifts to the preferenced base, through the process described in Part II above. If policymakers cannot compensate by further increasing the top marginal rates, because of the salience of this form of tax increases, the preferences for a portion of the tax base will constrain overall progressivity as rates on the remainder of the base will not rise enough to offset the revenue loss from poorly targeted preferences.

3. The Revenue-Maximizing Rate Constraint

The third condition, "the revenue-maximizing rate constraint" describes the scenario where policymakers determine to tax the wealthy at the revenue maximizing rate—the rate where additional rate increases will not generate any more revenue. At that point, policymakers simply cannot raise rates further to offset revenue loss from preferences for a portion.[234]

In this scenario, the progressive revenue-raising potential from this top rate will depend, in part, on whether taxpayers have an opportunity to shift from the higher-taxed base to a preferenced base. Even in the absence of such tax avoidance, the fact that part of the base isn't fully subject to the tax rate

234. That is, in the case of the salience of tax rates constraint, policymakers cannot raise the top marginal rate because of the political salience of rate increases. In the case of the "revenue-maximizing rate constraint," policymakers cannot raise the top marginal rate because doing so would not generate additional revenue.

increase would lower revenue. This effect is then magnified to the degree that taxpayers can substitute across the tax bases and shift away from the base subject to the higher rates.

The revenue-maximizing rate on a base varies with the amount of tax avoidance generated for any additional rate increase.[235] As the avoidance opportunities increase, the revenue-maximizing rate—and the revenue raised from this maximum rate—decreases.

This constraint would bind policymakers irrespective of whether the tax avoidance results in significant efficiency costs. Even if the taxpayer can avoid the higher rate at a low cost (and thus would even incur these costs at lower top rates), this behavior will still result in less revenue raised, and less overall progressivity resulting from the revenue maximizing rates. For the same reason, the constraint also binds policymakers even if they are not concerned with the efficiency costs incurred by the taxpayers subject to tax rate increases.[236]

According to some views in the literature, policymakers may be justified in setting top tax rates at or close to the revenue-maximizing rate. As described above, some scholars have argued that efficiency costs at the top of the distribution should not translate into social welfare loss, because there may be little social value in additional resources for the wealthiest taxpayers.[237] In that case, tax rates should be set at the revenue maximizing point, and the only social welfare losses from tax avoidance would result from the reduced revenue raised for the government and available for redistribution and public spending.[238]

As suggested above, policymakers do not necessarily operate in an optimal tax model. Irrespective of motive, however, policymakers will be bound by "the revenue maximizing rate constraint" if they raise rates sufficiently high, and preferences

235. This follows from the basic principle that the revenue leakage from taxation will vary with the elasticity of the base subject to tax. *See* Saez et al., *supra* note 165, at 8.

236. That is, the net result from the policymaker's perspective would again be lower revenue raised at the revenue-maximizing rate, irrespective of whether the revenue loss results from large or small efficiency costs incurred by the taxpayers.

237. *See supra* note 184 and accompanying text.

238. *See, e.g.*, Diamond & Saez, *supra* note 7, at 168–70.

that increase the opportunities for tax avoidance lower the potential ceiling of this revenue-maximizing rate.

The revenue-maximizing rate constraint is only relevant under a much more progressive income tax system with higher top margin rates. In the case of ordinary income tax rates, evidence suggests that this revenue-maximizing rate would be significantly higher than under current law.[239] Economists Peter Diamond and Emmanuel Saez estimate that this optimal revenue-maximizing rate would be approximately 73%.[240] This revenue-maximizing rate, however, depends on the tax avoidance opportunities available to taxpayers. The 2017 legislation's business tax preferences—and the new tax avoidance opportunities that they introduced—likely reduced this revenue-maximizing rate, and therefore the amount of revenue that can be raised from the wealthiest taxpayers at this revenue-maximizing rate.[241] This constraint is likely irrelevant for smaller tax rate changes based on rates today, but would be relevant for larger ones, including such proposals as the one introduced by Representative Ocasio-Cortez.[242]

B. PATH DEPENDENCY IN THE TAX SYSTEM

This discussion does not intend to suggest that political outcomes—or constraints—are inevitable. These constraints—particularly the "efficiency cost constraint" and "the salience of tax rates constraint"—are functions of politics, and preferences of policymakers and constituents, which can and do change. Some policymakers may feel more bound by some of these constraints than others. With that said, evidence suggests that these constraints do exist in the political process.[243]

In the same vein, the business preferences that are the subject of this Article are themselves the product of their own political forces and constraints, but these business tax preferences need not be considered inevitable outcomes of the political process. After all, they are new to the tax system as of the

239. *Id.* at 171.
240. *Id.*
241. *The 2017 Tax Legislation*, *supra* note 1.
242. Stracqualursi, *supra* note 6; *supra* note 6 and accompanying text.
243. *See supra* notes 217–20, 222–33, 236–39 and accompanying text.

2017 legislation and after passage remained unpopular with a significant portion of the electorate.[244]

These three constraints ultimately suggest a political path dependency—where the introduction of new tax preferences can decrease the probability of future progressive tax changes, assuming those preferences are maintained. Policymakers seeking to increase the progressivity of the tax system—and, specifically, the revenue raised from the wealthiest taxpayers—should seek to "reverse the ratchet" in order to reduce the probability that their effort will run aground on these barriers.

IV. IMPLICATIONS FOR TAX REFORM

This Part considers the implications of the progressivity ratchet—and how its effect depends on the particular legal rules defining the scope of new tax preferences—for evaluating the 2017 tax legislation and the future of progressive tax design.

Sections A and B first describe how the progressivity ratchet suggests an alternative assessment of the corporate rate reduction and Section 199A. As described above, critiques of the 2017 tax legislation in the literature have generally focused on its explicit distributional effects and the design of Section 199A.[245] At the same time, the corporate rate reduction received measured praise as a response to lower rates in foreign jurisdictions.[246] This Part reconsiders these assessments. In short, the corporate rate reduction and the pass-through deduction can both be understood as similarly mistargeted responses to low tax rates elsewhere in the system that were introduced in order to improve "neutrality" along specific margins in the tax law. Both changes will likely have the similar effect of increasing the efficiency cost of taxation and, because of political economy constraints, locking in a less progressive tax system over time—if these structures are retained.

Section C then describes how the progressivity ratchet in the 2017 legislation will obstruct future progressive tax reforms, such as recent proposals to raise the marginal rates on

244. Megan Brenan, *More Still Disapprove than Approve of 2017 Tax Cuts*, GALLUP (Oct. 10, 2018), https://news.gallup.com/poll/243611/disapprove-approve-2017-tax-cuts.aspx [https://perma.cc/JSH5-URCZ].

245. *See supra* Part I.C.

246. *See supra* Part I.C.

ordinary income earned by the wealthiest taxpayers. This analysis also explains the deeper distributional consequences of the changes in the 2017 legislation. Finally, Section D evaluates different reform options to "reverse the ratchet," which would in turn facilitate future progressive reforms.

A. REEVALUATING THE CORPORATE RATE REDUCTION

Many commentators on the 2017 tax legislation considered the corporate rate reduction something of a saving grace in an otherwise flawed bill. As described above, proponents argued that the corporate rate reduction would improve neutrality in the tax system and discourage U.S. MNCs from shifting income to low-tax jurisdictions by changing the location of reported profits or real economic investment.[247] This assessment, however, focuses narrowly on the corporate system in the international context. It fails to take into account the effects on the broader tax system—including both the significant opportunities for domestic tax avoidance that the low corporate rate generates and the ways in which a low corporate rate is likely to constrain the overall progressivity of the tax system due to the ratchet effect we describe.

First, the corporate rate reduction may not be justified under a traditional application of the neutrality rule and the optimal tax framework. The domestic and foreign profits of MNCs turn out not to be close substitutes, even after the corporate rate reduction. This might come as a surprise. After all, MNCs do shift large amounts of profits to foreign jurisdictions from the United States.[248] Kimberly Clausing estimates that in 2015 U.S. MNCs shifted approximately $309 to $379 billion in profits from the United States to lower-taxed foreign jurisdictions.[249] The corporate rate cut, however, may not meaningfully reduce profit shifting. For instance, Clausing estimates that cutting the U.S. corporate rate to 21% would only reduce the amount of shifted profits by $50 billion (resulting in a net revenue gain of only about $11 billion).[250] The Congressional Budg-

247. *See supra* Part I.C.1.

248. *See* Kimberly Clausing, Profit Shifting Before and After the Tax Cuts and Jobs Act 12–13 (Jan. 29, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3274827 [https://perma.cc/2J3V-93KM].

249. *Id.* at 13.

250. *Id.* at 30.

et Office similarly estimates that the 2017 legislation as a whole, including base protection measures and behavioral changes of foreign corporations, would reduce profit shifting out of the United States by only about $65 billion per year on average over the next eleven years—with the corporate rate cut responsible for only some portion of that amount.[251] One leading analyst of international capital flows finds, based on early post-2017 data, that the corporate rate reduction might have had virtually no effect on profit shifting.[252]

The reason for this modest expected reduction in profit shifting is that most MNCs shift profits to very low-tax countries. As a result, even with the lower U.S. corporate rate, these companies may still benefit from reporting profits abroad.[253] Thus, an even larger corporate rate reduction (entailing an even greater net revenue loss and ratchet effect across the rest of the tax system) would be necessary to induce MNCs to report these mobile profits in the United States. At the rates introduced in the 2017 tax legislation, however, taxpayers may still benefit by shifting profits to foreign jurisdictions.

The corporate rate reduction also may not have a significant effect in discouraging investment abroad and encouraging investment in the United States, because the location of real

251. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2018 TO 2028, at 124 (2018), https://www.cbo.gov/publication/53651 [https://perma.cc/R8KY-WN4X].

252. *See* Brad Setser, Opinion, *The Global Con Hidden in Trump's Tax Reform Law, Revealed*, N.Y. TIMES (Feb. 6, 2019), https://www.nytimes.com/2019/02/06/opinion/business-economics/trump-tax-reform-state-of-the-union-2019.html [https://perma.cc/KM6Z-6RWB] ("The global distribution of corporations' offshore profits—our best measure of their tax avoidance gymnastics—hasn't budged from the prevailing trend.").

253. Clausing, *supra* note 248, at 29 (describing a limited effect of the corporate rate reduction on profit shifting "since most profit shifting occurs with respect to the lowest taxed countries, and 21 percent is still well above that threshold"); Setser, *supra* note 252 ("Why would any multinational corporation pay America's 21 percent tax rate when it could pay the new 'global minimum' rate of 10.5 percent on profits shifted to tax havens, particularly when there are few restrictions on how money can be moved around a company and its foreign subsidiaries?"); *see also, e.g.*, CONG. BUDGET OFFICE, *supra* note 251, at 125 ("Because tax havens outside the United States will continue to have relatively low tax rates, CBO projects that most IP currently located there will remain there. For newly created or future IP, the changes resulting from the tax act and the fixed costs of transferring IP to foreign affiliates will probably deter some small amount of profit shifting.").

investment by MNCs may not be particularly sensitive to tax changes.[254] In other words, this evidence suggests that domestic and foreign real investments by MNCs are also not close substitutes. This phenomenon in part explains why, when evaluating the 2017 legislation as a whole, the Congressional Budget Office finds that by the tenth year after the changes, when the corporate rate cut is the only significant tax cut still in place, Gross National Product—the value of production attributable to U.S. nationals—would increase by merely 0.1%.[255] Policymakers also have other options to encourage domestic investments that are likely to more directly incentivize investment at a lower revenue loss than through a broad corporate rate reduction, and without introducing downward pressure on tax rates in other parts of the system. One example of such a policy is expensing of new capital investments.[256]

254. *See* Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. 433, 455 (2012) (concluding based on a cross-sectional study of countries and corporate tax rates that "there is no evidence that lower tax countries experience greater growth (or lesser declines) in gross fixed capital formation relative to GDP"); *see also* Paul Krugman, Opinion, *Tax Cuts and Leprechauns (Wonkish)*, N.Y. TIMES (June 15, 2018), https://www.nytimes.com/2018/06/15/opinion/tax-cuts-and-leprechauns-wonkish.html [https://perma.cc/L52X-2CX4] ("Multinational corporations move profits—as reported—around based on tax considerations; actual capital, and hence actual economic activity, not so much.").

255. *See* CONG. BUDGET OFFICE, LETTER TO THE HONORABLE CHRIS VAN HOLLEN, RE: EFFECTS OF THE 2017 TAX ACT ON INCOME ACCRUING TO FOREIGN INVESTORS 1 (2018), https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53772-2017taxacteffectsonincome.pdf [https://perma.cc/NJT6-SSMN]. This finding reflects a slightly increased capital stock but also subtracts out increased payments to foreign investors. Alan Auerbach suggests, however, that the effects on economic welfare in the United States may be more significant, if still somewhat modest. *See* Auerbach, *supra* note 138, at 115–16. Auerbach in fact cites CBO results as in part supporting this. *Id.* In part, this is because Auerbach focuses on increases in *domestic* product, which includes the increased income of foreign investors, as opposed to *national* product, which focuses on the incomes of U.S. nationals. In evaluating the benefits of a corporate rate cut in a unilateral reform by the United States, national product may be the more relevant metric.

256. For instance, Jason Furman and Robert Barro estimate that simply extending 50% bonus depreciation for equipment might have done more to boost output at one-sixth of the cost of the changes in the 2017 legislation. Robert J. Barro & Jason Furman, *Macroeconomic Effects of the 2017 Tax Reform*, BROOKINGS PAPERS ON ECON. ACTIVITY, Spring 2018, at 257, 304. Importantly, Furman and Barro explicitly do not account for the effect of the change in relative tax rates between the United States and other countries,

The corporate rate cut has likely only modestly reduced shifting of profits and investment out of the United States, but also preferenced a large additional portion of the corporate income tax base that would not have shifted abroad otherwise. In 2013, corporations reported approximately $1.3 trillion in net taxable income.[257] The corporate rate reduction extends this benefit of a 14% tax cut across the entire corporate taxable base, cutting revenues by almost $150 billion per year.[258] For the reasons described in the abstract presentation above,[259] a properly targeted rate reduction on the smaller tranche of MNC income that was in fact subject to profits shifting or shifting of investment locale within that rate range would have properly applied the neutrality principle, and thereby could have lowered the marginal efficiency cost of taxation while limiting additional revenue loss.[260] The broader and mistargeted corporate

and focus only on marginal tax rates in the United States and their effects on capital accumulation. They acknowledge that the relative tax rates might matter for real activity, but conclude the effect of the 2017 legislation on this margin—after taking into account both the rate cut and other international provisions—is ambiguous. *See id.* at 296–97 ("The impact of all these changes on reported income is less ambiguous and is likely to be positive as reported income is shifted back to the United States. This change would, however, not be associated with actual economic activity . . . ."). Others have argued that expensing may not be the most effective method to encourage new business investment. *See, e.g.*, Lily L. Batchelder, Accounting for Behavioral Considerations in Business Tax Reform: The Case of Expensing (Jan. 25, 2017) (working paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2904885 (arguing that rate reductions may be more salient and therefore more effective means of incentivizing investment).

257. JOHN A. KOSKINEN ET AL., REVENUE SERV., 2013 STATISTICS OF INCOME: CORPORATION INCOME TAX RETURNS 2 (2013), https://www.irs.gov/pub/irs-soi/13coccr.pdf [https://perma.cc/AR7W-MPRC].

258. Of course, the 2017 tax legislation also included some corporate base broadening measures, such as the limitation on interest expense deductions under I.R.C. § 163(j) (2017), which may be independently justified. This discussion focuses on the particular effect of the corporate rate cut.

259. *Supra* Part II.B.1.

260. For example, a "patent box" regime could achieve this function by limiting the preference to a narrow category of mobile income. *See* Bernard Knight & Goud Maragni, *It Is Time for the United States To Implement a Patent Box Tax Regime To Encourage Domestic Manufacturing*, 19 STAN. J.L. BUS. & FIN. 39, 47–48 (2013). For a discussion of the potential challenges with implementing a patent box regime, including the potential of "downward pressure on international anti-avoidance standards," see Lilian V. Faulhaber, *The Luxembourg Effect: Patent Boxes and the Limits of International Cooperation*, 101 MINN. L. REV. 1641, 1645 (2017). Commentators have noted that the FDII

rate reduction, however, will generate additional revenue costs which Congress will have to make up through tax increases elsewhere, while at the same time increasing the marginal efficiency cost from those other taxes.

Further, as described above, mistargeted preferences have the effect of increasing the amount of socially costly and revenue-losing substitution from higher- to lower-taxed activity by preferencing a broader range of activities which may then serve as substitutes for other activities in the residual higher-taxed base.[261] In this case, an expansion of the preference for all corporate income can increase the elasticity of taxable income—and therefore the marginal efficiency cost of higher rates—for all non-corporate income that can substitute into the corporate system.

In original analysis conducted for this Article, estimators at the Penn-Wharton Budget Model calculate that, absent the changes in 2017 legislation, taxpayers with income in excess of $500,000 would have earned approximately $530 billion in ordinary pass-through income in 2018, and almost all of that would have been higher-taxed if it were instead taxed in the corporate system.[262] With a 21% corporate rate (and absent Section 199A), however, roughly 85% of that income tax base, or over $450 billion, would now face lower tax rates in the corporate system than in the pass-through system.[263] With Section 199A in place, nearly 40% of this tax base would switch from facing lower rates in the pass-through system to lower rates in

regime, described *supra* note 97 and accompanying text, operates similarly to a patent box. *See* KYLE POMERLEAU, TAX FOUND., A HYBRID APPROACH: THE TREATMENT OF FOREIGN PROFITS UNDER THE TAX CUTS AND JOBS ACT 13 (2018), https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/ [https://perma.cc/J9NX-QWSZ]. Finally, policymakers may be constrained from preferencing some forms of mobile corporate income if such rules constituted export subsidies that violated international trade obligations. *See* Kamin et al., *supra* note 25, at 1499–1503 (discussing the possibility that the FDII regime violates WTO agreements).

261. *See supra* Part II.B.2.

262. E-mail from Richard Prisinzano, Senior Economist, Penn Wharton Budget Model, to David Kamin, Professor of Law, N.Y. Univ. Sch. of Law (Oct. 5, 2018, 3:56 PM EST) (on file with authors) [hereinafter Oct. 5 Prisinzano E-mail]; Feb. 13 Ricco E-mail, *supra* note 28.

263. These new estimates from Penn-Wharton assume that each firm distributes approximately half its annual profits as dividends. Oct. 5 Prisinzano E-mail, *supra* note 262. Of course, the proportion of profits distributed by each firm will vary with their unique economic circumstances.

the corporate system.[264] As a result, the corporate rate reduction—if it is retained—could result in significant shifting over time from the pass-through to the corporate systems.[265]

As described above, Congress could have also addressed the problem of profit shifting by MNCs in other ways that

264. *Id.*

265. The amount of shifting from the pass-through to the corporate systems will depend on the sensitivity of the choice of entity decisions to the tax rate differential between the systems. Empirical studies of this question in the late 1990s suggested that choice of entity decisions were relatively insensitive to the tax rate differential. *See, e.g.*, Austan Goolsbee, *Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax*, 69 J. PUB. ECON. 143, 150–51 (1998) ("The evidence indicates that taxes played a statistically significant role in organizational form decisions from 1900–1939 but the magnitude was quite small."); Jeffrey K. Mackie-Mason & Roger H. Gordon, *How Much Do Taxes Discourage Incorporation?*, 52 J. FIN. 477, 478 (1997) ("The measured effects are relatively small . . . ."). However, those findings also included the responses of publicly-traded firms—which may be relatively insensitive to the tax rate differential. As a result, these findings are not good guides for assessing the sensitivity of current pass-throughs to changes in the tax rate differential, since most pass-throughs are closely-held firms. *See* Karin Edmark & Roger H. Gordon, *The Choice of Organizational Form by Closely-Held Firms in Sweden: Tax Versus Non-Tax Determinants*, 22 INDUS. & CORP. CHANGE 219, 222 (2013) ("All of these studies, though, use aggregated . . . data, thereby including widely held firms that have a clear choice of organizational form as well as closely-held firms where the choice can depend much more on particular tax and non-tax factors."). Subsequent studies focused on closely-held firms found much greater sensitivity to the tax rate differential. *See* Edmark & Gordon, *supra*, at 223 (finding large effects of tax rates on choice of entity in Sweden among closely-held firms); Austan Goolsbee, *The Impact of the Corporate Income Tax: Evidence from State Organizational Form Data*, 88 J. PUB. ECON. 2283, 2284 (2004) (finding sensitivity to tax rates in the retail sector—where firms tend to be closely held—between five and fifteen or more times greater than in the previous studies). These empirical studies are also limited by the fact that that sensitivity to tax rate differentials may also depend on the particular rate environment and choice of entity rules at the time. For instance, a further increase in individual income tax rates could result in relationships between the systems not reflected in these prior studies. *See* Richard Prisinzano & James Pearce, *Tax-Based Switching of Business Income* 11, 19 (Penn Wharton Budget Model, Working Paper No. 2018-2, 2018), http://budgetmodel.wharton.upenn.edu/issues/2018/3/16/w2018-2 [https://perma.cc/7BGU-HX76]. In light of the possible limitations of these earlier findings in the current rate environment, we use data from the Penn Wharton Budget Model to help illustrate the magnitude of the pass-through income that could shift to the corporate system in response to higher individual rates, even though the empirical work to date doesn't provide a definite answer to exactly how much income will shift in response to particular rate differentials.

would have avoided these structural pressures on the remainder of the tax base. The 2017 tax legislation in fact introduced base-protection measures meant to target the types of tax planning activities that tend to shift profits out of this country, and Congress may be able to improve these rules.[266]

In sum, Congress opted for a broad-based corporate rate reduction, which largely failed to solve the problem of profit shifting by MNCs and likely had a relatively muted effect on investment. At the same time, the change introduced a new preference that increased the efficiency cost of taxation in the income tax system and reduced the revenue raised at any given rate in the individual income tax. This effect, combined with the political economy constraints described above, threatens to undermine the overall progressivity of the system and progressive reforms to the individual income tax in particular.

To describe this dynamic somewhat differently, proponents of the large corporate rate reduction have not answered the question of how they envision this reform interacting with the individual income tax. This omission is troubling within the confines of an optimal income tax analysis—since it increases the efficiency loss associated with raising revenue. It is even more problematic, however, in light of political economy constraints and the likelihood that revenue lost to the corporate rate cut will not be made up with higher individual rates for the reasons described in Part III. A low corporate rate thus threatens to put the tax system on a path toward less progressivity overall.

B. REEVALUATING SECTION 199A

Our analysis also suggests a somewhat more nuanced assessment of the Section 199A pass-through deduction. As we and others have suggested in previous work, the provision is a policy mistake.[267] Reaching that conclusion, however, requires seriously considering the trade-offs in introducing a new preference in response to an existing preference. Further, the harm from Section 199A is ultimately different from—and worse than—the harm the previous literature has described. The progressivity ratchet explains why Section 199A is likely to result

266. *See supra* notes 98–99; *infra* notes 308–13 and accompanying text.

267. *See supra* Part I.C.1.

in more than just immediate revenue loss and unnecessary complexity, but also a less progressive system over time.

As described in Part II, it is possible in theory for a new preference to reduce harms from a pre-existing preference. In this case, Section 199A could be responsive to the preference for corporate income (which is itself a poorly targeted preference to address international pressures). If Section 199A were in fact well-targeted on activity that would otherwise shift to lower taxes in the corporate system, then Section 199A could be consistent with the neutrality rule and help mitigate some of the political dynamics generating the progressivity ratchet as a result of the corporate rate reduction.

In this case, assessing the wisdom of Section 199A requires, first, evaluating the legal rules defining the availability of the preference and whether these rules preference activities that would otherwise substitute to lower rates in the corporate system.[268] Section 199A surely mitigated some such substitution and also avoided preferencing some activities that could not have taken advantage of the corporate system. The original calculations performed for this Article by analysts at the Penn Wharton Budget Model indicate that, as of 2018, approximately $200 billion of pass-through profits from taxpayers earning over $500,000 wouldn't face a tax incentive to shift to the corporate system with Section 199A in place, as compared to a tax system without it.[269] Perhaps more importantly, they estimate that many taxpayers in this income range benefiting from Section 199A may now pay tax at rates close to what they would pay in the corporate system.[270] Thus, Section 199A likely discouraged some revenue-losing and costly substitution as a result.

Some of the legal rules limiting access to Section 199A will in fact exclude taxpayers who could not easily substitute to the corporate system. For instance, employees—who do not qualify

268. *See supra* Part II.B.2.

269. *See* Oct. 5 Prisinzano E-mail, *supra* note 262.

270. *See* Prisinzano & Pearce, *supra* note 265, at 20. Specifically, the pass-through profits of taxpayers benefiting from Section 199A and earning more than $500,000 would, on average, face a tax rate only about 1% lower than profits of these taxpayers earned in the corporate system, assuming the corporation distributed an average proportion of its earnings. Authors' calculations based on the Penn Wharton Budget Model. *Id.*

for Section 199A[271]—could also not readily take advantage of corporate form and avoid the second layer of tax in that system, since personal holding company and retained earnings rules would be significant barriers for them.[272] Section 199A's requirement that firms owned by high-income individuals must have employee wages, tangible investments, or a combination thereof[273] might also be seen as excluding from the Section 199A benefit firms that would have trouble justifying retaining earnings in the corporate system.[274]

In other cases, however, Section 199A replicated the corporate rate reduction's mistake of failing to properly target mobile MNC income, and preferenced a sector of the tax base that could not have otherwise benefitted from the corporate rate reduction. This consequence may be inevitable, to a degree, in the case of any pass-through preference, regardless of how it is designed. Congress cannot easily design rules that target taxpayers and activities which would otherwise substitute into lower tax rates in a different tax system without simply replicating the exact same system—and, thus, the exact same substitution that Congress is attempting to mitigate. For instance, service-oriented partnerships might have trouble restructuring their profit-sharing arrangements within a corporate structure because partners may be rewarded different shares of profits each year depending on their productivity[275]—and yet such partner-

271. *See supra* note 90 and accompanying text.

272. *See supra* note 69 and accompanying text.

273. *See supra* note 92 and accompanying text.

274. Specifically, firms without significant numbers of employees or tangible investments would likely have a harder time on average than other firms avoiding the accumulated earnings tax if profits are retained. For a brief description of the tax, see *supra* note 68 and accompanying text. Without operations involving investment in human or physical capital in the firm, companies might not be able to justify retaining a substantial share of profits for "reasonable needs" of the business.

275. These service businesses would first encounter the personal holding company rules and the surtax that could apply to income retained from "personal service contracts." *See supra* note 67 and accompanying text. These rules can be avoided, however, if the firm has enough owners or the contracts do not specify which individuals will provide the services. *See supra* note 70. The more challenging issue might be awarding different amounts of compensation to owners depending on their service but still having those profits characterized as corporate profits retained in the firm. The risk, from the perspective of the owners, is that—because of the variation in value (with potentially different amounts of stock awarded a given year based on the services performed in

ships are not wholly barred from accessing the deduction. Instead, Section 199A draws arbitrary distinctions between professional services that receive the deduction and those that do not, which do not seem to correlate with any distinction between firms that would otherwise shift to the corporate system and those that would not.[276] Section 199A's mistargeting leads to windfall gains to many taxpayers who qualify for Section 199A but who would not have substituted to the corporate system and also new opportunities for other taxpayers to plan their way into Section 199A and avoid the top individual rates.[277]

This framework suggests a basic trade-off when assessing Section 199A: the potential benefit of preventing some taxpayers from shifting into the corporate system versus the potential costs of granting windfall gains to some taxpayers and introducing additional tax planning opportunities for others. Given the heterogeneity in tax planning opportunities in the corporate and pass-through systems, the mistargeting effects of Section 199A seems likely to predominate, though the question is an empirical one.

Further, this framework also shows that the relevant question is not whether Section 199A will, on average, tax eligible entities at similar tax rates as corporations. "Average rate neutrality" between systems should not be the goal. Rather, the goal should be treating close substitutes more neutrally, and Section 199A—by preferencing activities that would not otherwise shift into the corporate system and creating new disparities within the individual income tax system—fails to do that.

In the end, the greatest potential harm of Section 199A—like the corporate rate cut—may not be the immediate revenue loss or additional complexity. Rather, the even greater harm might be from the way in which it constrains policymakers from raising revenue from the highest income taxpayers through future reforms. If corporations and pass-through entities retain their current mistargeted preferences, these prefer-

that year)—this award may be characterized as either a disproportionate distribution (and therefore as a dividend) under I.R.C. §§ 301, 305(b)(2) (2017) or as employee compensation under I.R.C. § 83 (2017).

276. *See supra* notes 93, 110–15 and accompanying text. For example, there is no clear reason why architects or engineers may be more likely to benefit from the corporate system than lawyers and doctors.

277. *See supra* notes 110–15 and accompanying text.

ences will serves as barriers to higher rates on the rest of the tax base.

C. THE CHALLENGE TO PROGRESSIVE TAXATION

The progressivity ratchet also explains the relationship between the changes in the 2017 legislation and proposals to increase the progressivity of the tax system by raising the top rates on high income taxpayers.

The federal government faces significant additional financing needs. The CBO finds that the government will need to either raise revenue or cut spending by approximately 2% of GDP starting in 2019 (around $400 billion) just to stabilize the debt at its current share of GDP over the next three decades.[278] That figure would approximately double if temporary current policies like the expiring tax cuts and relief from the spending sequester are continued.[279] Congress may also require additional funding to fund critical new public investments. For example, as described above, Representative Ocasio-Cortez proposed a tax rate increase 70% to specifically raise revenue for responses to climate change.[280] Finally, a more progressive tax system may be necessary to address economic inequality and its attendant social and political harms.[281]

Raising top tax rates can help address these policy challenges, but the progressivity ratchet undermines the effectiveness of this response and the likelihood that policymakers would choose to raise as much as they would otherwise from the highest income taxpayers. Because of the progressivity ratchet, the structure of the 2017 tax legislation will obstruct

278. CONG. BUDGET OFFICE, THE 2018 LONG-TERM BUDGET OUTLOOK 5 (2018), https://www.cbo.gov/system/files?file=2018-06/53919-2018ltbo.pdf [https://perma.cc/L4UD-WUSP].

279. The CBO projects that continuing these temporary current policies would add about 2% of GDP to the deficit by 2028. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: 2019 TO 2029, at 107 fig.5-2 (2019), https://www.cbo.gov/system/files/2019-03/54918-Outlook-3.pdf [https://perma.cc/QP89-ZS7L] (showing deficits under the "alternative fiscal scenario").

280. Stracqualursi, *supra* note 6.

281. *See, e.g.*, *Income Inequality*, OECD, https://data.oecd.org/inequality/income-inequality.htm [https://perma.cc/ZA8R-RPPN] (comparing inequality across countries after taxes and transfers and finding that the United States has among the highest levels of inequality in the OECD and the highest among the G-7 countries); *see also* Saez & Zucman, *supra* note 8; *supra* note 8 and accompanying text.

efforts to increase the revenue raised by the highest income taxpayers through future progressive reforms. Whether future rate increases finance current commitments, new ones, or curtail economic inequality, the progressivity ratchet will undermine all of these goals and reduce the revenue raising efforts while increasing the efficiency costs from these increases.

Consider once again the three possible constraints policymakers may face on raising taxes on the wealthy. Because of the progressivity ratchet, further tax increases in the individual income tax will entail greater efficiency costs, which may constrain policymakers from raising rates if they face the "efficiency cost constraint." Similarly, the progressivity ratchet will result in lower revenue raised at any chosen rate in the individual income tax, whether that rate is the revenue-maximizing rate, in the case of the "revenue-maximizing rate constraint" or some lower rate determined by the political process, in the case of the "salience of tax rate constraint." In fact, if these constraints are particularly confining, the progressivity ratchet could lead to future regressive tax cuts or cuts to government programs.[282]

Proposals by Representative Ocasio-Cortez and by economists for higher marginal rates on the wealthy illustrate the challenge of the progressivity ratchet. Substantially increasing the top tax rate will raise more revenue from the wealthy at lower efficiency costs if taxpayers cannot easily shift their activities to preferenced portions of the tax base. While some commentators have already highlighted how these higher tax rates may not raise revenue if activity shifts over to the corporate sector,[283] the emerging conversation on progressive tax reforms has largely ignored how preferences for business income may obstruct progressive reforms.[284] For example, Diamond

282. For example, the efficiency costs of higher taxes on the wealthy will increase in the presence of the progressivity ratchet, and politicians may be sensitive to imposing these costs.

283. For instance, analysts at the Penn-Wharton Budget Model explicitly considered the potential significance of taxpayers shifting to the corporate system in response to higher individual rates and found large potential shifting responses. *See* John Ricco & Rich Prisinzano, *The Hidden Revenue Cost of a 70% Top Marginal Rate*, PENN WHARTON BUDGET MODEL: ECON. MATTERS (Jan. 24, 2019), http://budgetmodel.wharton.upenn.edu/issues/2019/1/24/the-hidden-revenue-cost-of-a-70-top-marginal-rate [https://perma.cc/K5GJ-32X6].

284. Some analysis entirely ignored the ways high income taxpayers could avoid the tax increase, including by taking greater advantage of the business

and Saez's estimates of the optimal top rate depend upon a particular legal framework, which likely does not account for the types of tax reduction opportunities introduced by the 2017 tax legislation.[285]

The progressivity ratchet could significantly limit the revenue raised by higher rates on ordinary income. Before considering the effects of the 2017 tax legislation, taxpayers with income above $500,000 were projected to earn approximately $1.5

preferences. *See* Jeff Stein, *Ocasio-Cortez Wants Higher Taxes on Very Rich Americans. Here's How Much Money That Could Raise*, WASH. POST: WONKBLOG (Jan. 5, 2019), https://www.washingtonpost.com/business/2019/01/05/ocasio-cortez-wants-higher-taxes-very-rich-americans-heres-how-much-money-could-that-raise/?utm_term=.82b45331b81e (overlooking corporate tax rates as a method of avoiding increased marginal income rates). Other analysis did incorporate such avoidance behavior but adopted the same assumptions used before the 2017 legislation and without seriously considering the ways in which the combination of a low corporate tax rate and the pass-through deduction might render the earlier assumptions were inapplicable. *See* Kyle Pomerleau & Huaqun Li, *How Much Revenue Would a 70% Top Tax Rate Raise? An Initial Analysis*, TAX FOUND.: TAX POL'Y BLOG (Jan. 14, 2019), https://taxfoundation.org/70-percent-tax-analysis/#_ftnref4 [https://perma.cc/TGW6-EHY9]; Ricco & Prisinzano, *supra* note 283.

285. Diamond and Saez recognize that the revenue-maximizing rate depends on the relevant legal rules. The key variable in their estimate is the elasticity of taxable income—the sensitivity of the tax base to changes in the tax rate. *See supra* Part II.A.1 for further description of this term. There are a range of possible estimates for that parameter, and Diamond and Saez in fact calculate a different revenue-maximizing rate of 54% based on an alternative estimate of the elasticity. They point to changes in the legal framework as potentially explaining some of the variance in elasticity estimates, writing: "the tax avoidance or evasion component of the elasticity . . . is not an immutable parameter and can be reduced through base broadening and tax enforcement." Diamond & Saez, *supra* note 7, at 173. As this Article details, the new preferences for corporate and pass-through income are likely to result in significantly higher elasticities in the individual income tax system. Substitution between the individual and corporate systems is not new, but, as described in Parts IV.A–B, the 2017 law likely substantially increased the volume of income that would shift away from income tax rate increases using the business preferences. In fact, some of the highest estimates of the elasticity of taxable income are associated with tax rate changes that, because of the specific legal frameworks and rates involved, led to substantial shifts in business form. *See, e.g*, Emmanuel Saez et al., *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LIT. 3, 21 tbl.1, 33–34 (2012) (finding high elasticity of taxable income for the top 1% after individual income tax rate cuts in 1981 and 1986 and noting that a substantial share of the effect in 1986 appeared to be a shift from corporations to pass throughs, and especially to S corporations).

trillion of ordinary income in 2018.[286] Without taking into account any behavioral responses, a 1% increase in the tax rate on this income would generate approximately $15 billion of additional revenue per year. According to original analysis conducted for this Article by the Penn-Wharton Budget Model, however, roughly one-third of that ordinary income is in the form of pass-through profits that were previously tax-advantaged in the pass-through system, and could now shift to the corporate system in the case of a sufficient rate differential between two systems.[287] If Congress only increases rates in the individual income tax—and creates a sufficiently high rate differential with the corporate system—much of that pass-through business income as well as other forms of individual income could shift to the corporate system, meaning that one-third or more of that $15 billion per year of potential revenue gain could dissipate.[288] In effect, raising the ordinary income rate without breaking the progressivity ratchet would leave a diminished residual base of non-business income that, for one reason or another, cannot shift away from this higher rate. Because of the dynamics described in Part III, it seems unlikely that policymakers would be willing to raise rates enough on the residual

286. Authors' estimate based on calculations in Feb. 13 Ricco E-mail, *supra* note 28, and Oct. 5 Prisinzano E-mail, *supra* note 262.

287. Feb. 13 Ricco E-mail, *supra* note 28.

288. One-third may in fact be a low estimate, as a large enough differential between the individual and corporate rate would probably entail further revenue leakage to the corporate system. Specifically, wage income could potentially also shift from the individual income to corporate system, and these estimates did not account for this possible leakage. As described above, the corporate anti-abuse rules largely prevent most employees from forming corporations and retaining earnings to avoid the second layer of corporate tax. *See supra* note 69. However, if individual income tax rates rise and the corporate rate or dividend rates do not increase commensurately, this dynamic could create a unique opportunity in the history of the tax rules for taxpayers to earn income through a corporation, immediately receive a distribution of the income and pay the second layer of tax, and still achieve significant tax savings. The "reasonable compensation" requirement could limit shareholder-employees in a corporation from taking advantage of this strategy, but taxpayers have successfully avoided the application of this doctrine in eras with far less potential tax savings at stake. *See* U.S. GOVT. ACCOUNTABILITY OFFICE, ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 26–29 (2009), https://www.gao.gov/new.items/d10195.pdf [https://perma.cc/3C3N-952K] (describing the substantial difficulty that the IRS has had in enforcing the "reasonable compensation" doctrine).

non-preferenced base to make up for the income that has shifted to the preferentially taxed bases.

D. REVERSING THE RATCHET

The progressivity ratchet explains why the corporate rate reduction should be understood as a core structural failing of the 2017 tax legislation and an obstacle to future progressive reforms. This Section describes and compares different options to "break the ratchet"[289] and facilitate future rate increases. It also situates different reform proposals in the prior literature within this Article's framework.

1. Restoring the Relative Corporate Penalty

Congress could break the ratchet by unwinding the structural changes in the 2017 legislation and restoring the prior status quo of a relative corporate penalty for most taxpayers.[290] In this case, Congress could also eliminate Section 199A at a lower social cost, because fewer pass-through businesses would otherwise shift into the corporate system. As suggested above, it is desirable for Congress to eliminate Section 199A even if it preserves the low corporate rate, but this change could induce revenue loss and efficiency costs from taxpayers shifting into the corporate system.[291] If Congress raised the corporate rate

289. Of course, Congress can also break the ratchet through a combination of these options. The discussion that follows isolates the different factors in order to illustrate and assess the full range of options available to Congress.

290. In this case, a relative "corporate penalty" refers to the case of a higher effective tax on corporate income than on income earned through a pass-through for most taxpayers. Under prior law, even those taxpayers able to entirely eliminate the second individual layer of tax on income earned through a corporation still faced a top corporate rate that was within the range of top rate on income earned directly. *See supra* notes 43–47 and accompanying text. Restoring the corporate penalty would require increasing the corporate rate to the same range as the top individual rate of approximately 40.8%. In this case, most taxpayers have relatively little to gain from earning income through a corporation rather than directly, under even the most favorable circumstances. Of course, any particular taxpayers or firms will face different effective rates in the corporate system, depending on such factors as how regularly the firm distributes earnings.

291. *See supra* Part IV.B.

sufficiently, however, Section 199A would become entirely unnecessary.[292]

Thus far, policymakers and commentators have not generally embraced restoring the relative corporate penalty from prior law, even among those supporting a more modest corporate tax rate increase.[293] However, the prior world of a relative corporate penalty offered critical advantages over the post-2017 framework. First, for closely-held firms, the corporate system with a relative penalty was largely irrelevant. These closely-held firms would, for the most part, not "check the box" to shift from the pass-through to the corporate system, even if Congress then raised the individual rates. These firms could otherwise shift with relative ease across this margin,[294] and a relative corporate penalty which induces them to shift into the pass-through system would therefore have the effect of treating close substitutes neutrally.

This scenario would largely reserve the corporate system for publicly-traded companies that cannot shift to the lower rates in the pass-through system without losing access to the public equity markets. The empirical literature indicates—although the question warrants additional study—that firms may not be all that sensitive along this margin.[295] As a result,

292. That is, in this case Congress would not have any reason to preference pass-through income, since taxpayers would not have the option of better treatment under the corporate system.

293. *See, e.g.*, Graetz, *supra* note 23, at 320 ("Both before and after the legislation, Democrats urged a corporate tax rate of 25% to 28%."); Jason Furman, Opinion, *Repeal and Replace the Trump Tax Cuts*, WALL ST. J. (Jan. 25, 2018), https://www.wsj.com/articles/repeal-and-replace-the-trump-tax-cuts-1516925433?mod=article_inline (calling for a corporate rate of 25% to 28% but full elimination of the pass-through deduction); Paul M. Krawzak, *House Democrats' Budget To Assume Corporate Tax Increase*, ROLL CALL (Jan. 7, 2019), http://www.rollcall.com/news/politics/house-democrats-budget-to-assume-corporate-tax-increase [https://perma.cc/9MYT-SPUG] (reporting that the Democratic House budget resolution would assume a corporate rate of between 25% and 28%).

294. *See supra* note 265.

295. See *supra* note 265 for a discussion of this empirical evidence. *See also* SHAVIRO, *supra* note 22, at 32 ("Corporate tax status may . . . be hard to avoid when prospective investors would value the advantage of access to public capital markets."); Emily Cauble, *Taxing Publicly Traded Entities*, 6 COLUM. J. TAX L. 147, 162–64 (2015) ("Because equity holders have strong non-tax reasons to demand liquidity, entities cannot easily abandon public trading in order to avoid corporate tax treatment.").

closely-held and publicly-traded companies may not be close substitutes.[296] Of course, any substitution across this margin—by companies electing to be closely-held rather than publicly-traded—would entail some revenue loss and social cost.[297] Those efficiency costs would include non-tax costs to the business of financing privately rather than through public equity markets, and any additional costs to society of less transparency in the business sector. Considering that there does not appear to be much substitution along this margin, those costs may be more desirable, however, than the alternative of allowing all privately-held companies to engage in tax-motivated planning across the corporate and pass-through systems.

Raising the corporate rate would also increase pressure on the international margin, which motivated the corporate rate cut in the 2017 legislation in the first case.[298] As described above, however, taxpayers may not be induced to shift profits and real investment to the U.S. even after the corporate rate cut, at least within the range of relative tax rates introduced in the 2017 legislation.[299] The potential cost of any shifting along the international margin, however, may be desirable in order to treat other close substitutes—privately-held firms in the corporate and pass-through systems—more neutrally in the tax system. Further, as described below, the corporate penalty could be combined with other rules more effectively targeted on mobile income, in order to raise revenue while still reducing tax-motivated shifting of profits and investment.[300]

In addition to likely treating close substitutes more neutrally, the solution of a relative corporate penalty for publicly-traded companies offers the additional benefit of reserving the corporate system for companies which can take advantage of its administrative benefits. Scholars justify the corporate system on the grounds that entity-level taxation is administratively superior for the largest firms with regularly traded interests.[301] A relative corporate penalty required for publicly-traded com-

296. *See* Cauble, *supra* note 295, at 163.

297. *See* SHAVIRO, *supra* note 22, at 33 ("[I]f the tax system penalizes use of the corporate form, businesses may end up being discouraged from going public . . . .").

298. *See* Graetz, *supra* note 23, at 326–27.

299. *See supra* notes 249–57 and accompanying text.

300. *See infra* note 312 and accompanying text.

301. *See supra* note 33 and accompanying text.

panies would align the corporate system with this rationale, while also mitigating the ratchet and limiting the systemic consequences for the rest of the tax system.

2. Rule-Based Solutions

Restoring the corporate penalty would mitigate the ratchet by effectively reserving the corporate system for publicly-traded companies, and preventing substantial substitution into the corporate system as individual income tax rates rise. Congress could also attempt to break the ratchet without restoring the relative corporate penalty by instead changing the rules governing the business tax system, through different reform options proposed in the prior literature.

These rule-based solutions may be divided into two broad categories. First, "targeting" rules would maintain preferences for corporate or pass-through income but seek to more accurately target these preferences to income that would in fact otherwise shift to other preferences. Alternatively, "neutrality" rules would instead eliminate or reduce preferences in the tax law, and consequently apply similar tax rates to foreign and domestic income as well as corporate and pass-through income earned by individual taxpayers and firms.

Targeting rules. Targeting rules would change the legal criteria governing which taxpayers can access preferential rates in the corporate or pass-through systems. Some of these changes would fall under what are often termed "anti-abuse" rules. For example, Congress might still offer preferential tax rates in the corporate system but limit access to these preferences. Congress might attempt to strengthen the rules limiting how much earnings can be retained (although there are not obvious ways to do so)[302] or restore the rules limiting corporate tax benefits for personal service corporations.[303] Similarly, Congress

302. *See* Glogower, *supra* note 55, at 965 (describing the challenge in strengthening the accumulated earnings tax rules without penalizing business with "a legitimate interest in retaining corporate earnings").

303. For example, Professor Shaviro has called for reinvigorating the personal service corporation regime as a way of mitigating the effects of a lower corporate rate. Shaviro, *supra* note 25, at 54 ("Had Congress continued to object, as it traditionally had, to use of the lower corporate rate to make corporations a convenient tax shelter for non-employee high-earners, it could easily have used the [personal service corporation] rules to address this issue.").

could attempt to preserve the Section 199A preference but improve the rules limiting qualification for the deduction.[304]

Other targeting rule changes could explicitly limit access to the corporate system. For example, scholars have proposed limiting the choice of entity through strict qualification rules taxing all closely-held corporations under the pass-through system and reserving the corporate form for publicly-traded entities.[305] This solution would, like the restoration of the corporate penalty, make it substantially harder for closely-held firms to access the corporate system to achieve tax savings. At the same time, this change would prevent publicly-traded companies from accessing tax reduction opportunities in the pass-through system. This solution would prevent firms from shifting between systems and therefore mitigate the progressivity ratchet effect resulting from different tax avoidance opportunities across two tax systems.

Targeting rules of this variety, if feasible, could improve the current structure introduced by the 2017 tax legislation and help narrow mistargeted preferences, but may ultimately be less desirable than the alternative option of restoring the relative corporate penalty. On the one hand, these targeting rules could limit the scope of these preferences and could more accurately target these preferences on the activities subject to substitution into other preferences, such as shifting profits and investment abroad. On the other hand, the targeting may still preserve the preference for a significant tranche of income that would not otherwise substitute toward another preference.

For instance, consider a targeting rule limiting corporate status to publicly-traded firms. This rule could eliminate the revenue losing substitution of closely-held firms to the corporate sector. Such a rule, however, would not change the fact that foreign profits and investment are not close substitutes for U.S. profits and investment at current rates, and that the rate cut extends to a large domestic corporate tax base. As a result, many corporations could still enjoy a significant windfall, which would necessitate higher rates elsewhere in the system (or

304. *See generally* GREENBERG & KAEDING, *supra* note 23.

305. *See, e.g.*, Toder, *Require Firms To Be Taxed as Pass-Throughs*, *supra* note 143 (proposal limiting the corporate system to publicly-traded companies). These rules would have a different effect, however, as part of a corporate integration reform. *See infra* note 313 and accompanying text.

spending cuts) without significantly discouraging the shifting of profits and investment. Targeting rules improving Section 199A would encounter a similar challenge in identifying pass-through taxpayers that are most likely to substitute toward corporate form, and there are no obvious ways to narrowly target them.

Alternatively, Congress could introduce targeting rules that explicitly preference a narrow scope of activities—such as rules that explicitly preference profits considered attributable to mobile intellectual property.[306] In this case, Congress would improve the targeting by isolating and preferencing the particular activities subject to substitution, rather than by broadly preferencing all corporate income and then attempting to introduce rules limiting the availability of the preference.[307]

In the end, the utility of targeting rules will depend on whether the improved targeting justifies the remaining preferences for corporate and pass-through income, and therefore more effectively applies the neutrality principle. In many cases targeting rules may be insufficient and would leave in place mistargeted preferences that still fail to treat close substitutes more neutrally, at least as compared to reverting to a relative corporate rate penalty. At the same time, many of these targeting rules could at least limit the ratchet effect resulting from the changes in the 2017 legislation, even if they may not be the most desirable option for policymakers.

Neutrality Rules. Congress could also break the progressivity ratchet by eliminating the margins that potentially justify additional preferences in the tax system. That is, Congress may be able to reduce or eliminate an initial preference, instead of responding to it by introducing additional preferences.

Some of these reforms would maintain the basic role of a corporate income tax but fundamentally change the treatment

306. See, for example, Knight & Maragni, *supra* note 260 (describing the possibility of using a "patent box"), for certain features of the 2017 legislation designed to address the taxation of mobile corporate profits.

307. That is, even a broad preference that is subsequently narrowed through eligibility rules could still unnecessarily preference a large portion of the tax base. Narrowing the preference also may fail to effectively target the remaining preference to activities that would otherwise shift to another preferenced based, and could disallow the preference for activities that are in fact susceptible to shifting.

of foreign income in that system.[308] For example, the 2017 tax legislation implemented some of these reforms through the GILTI and BEAT rules which, respectively, imposed a global minimum tax on foreign income and sought to address profit shifting out of the United States by both U.S. and foreign firms.[309] Congress could retain, and possibly improve these rules,[310] to limit the incentive for global profit shifting. These rules would treat MNC profits reported domestically and abroad more neutrally, and if successful, could then allow for a higher rate on other corporate income and on individual income.[311] These measures could also be combined with a relative corporate tax penalty, to both reduce substitution across the international margin and between the domestic pass-through and corporate systems.[312]

Other "neutrality rule" changes would fundamentally reform the corporate system and shift the economic locus of taxation from the corporation to individual shareholders through different methods of corporate integration.[313] These proposals

308. Prior works on corporate income tax reform have similarly suggested that preferencing certain forms of mobile corporate income could allow for higher rates—while minimizing efficiency costs—on the remainder of the corporate tax base. *See, e.g.*, SIR JAMES MIRRLEES ET AL., TAX BY DESIGN: THE MIRRLEES REVIEW 440 (2011) (suggesting the efficiency benefits from taxing highly mobile corporate rents at lower rates than location specific rents); Michael Keen, *Preferential Regimes Can Make Tax Competition Less Harmful*, 54(4) NAT'L TAX J. 757, 757 (2001) (arguing that preferential tax regimes can enable countries "to confine their most aggressive tax competition to particular parts of the tax system").

309. *See supra* notes 98–99 and accompanying text.

310. *See, e.g.*, Kamin et al., *supra* note 25, at 1496–97 (arguing that the GILTI rules could be improved by adopting a "per-country minimum tax rather than one done on a global basis").

311. As described *supra* notes 257–59 and accompanying text, however, these pressures may be exaggerated in all events.

312. In this case, the neutrality rule could address the international margin between domestic and foreign income while the relative corporate penalty could address the domestic margin between the corporate and pass-through systems. But see the possible obstacles to these reforms described *supra* note 260. *See also* MIRRLEES ET AL., *supra* note 308, at 444 (describing the "practical difficulties" and potential violation of international agreements in preferencing mobile forms of income).

313. *See, e.g.*, U.S. DEPT. OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 1–14 (1992) (describing the distortions caused by the separate corporate tax and how they would be alleviated through corporate integration); ERIC TODER &

have multiple aims. First, U.S. individuals—because they are taxed on their worldwide income—cannot readily shift income across borders to try to avoid U.S. rates.[314] As a result, these reforms could reduce the preference for foreign income. Second, these reforms would help align the tax rates and preferences across the corporate and pass-through systems, thus reducing opportunities for revenue-losing substitution within the domestic income tax base.[315]

This second set of neutrality rules involve much more dramatic changes to the business tax system and could treat income more neutrally, both across borders and across business forms. This approach, however, may present other disadvantages. For instance, recent research has shown that a significant share of corporate stock is held by non-taxable people or entities, such as retirement accounts, pension funds, and

ALAN D. VIARD, URBAN-BROOKINGS TAX POLICY CTR., A PROPOSAL TO REFORM THE TAXATION OF CORPORATE INCOME 17–18 (2016), https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000817-a-proposal-to-reform-the-taxation-of-corporate-income.pdf [https://perma.cc/XT2P-LLV9] (proposing to tax interests in publicly-traded corporations at the individual level through "mark-to-market taxation" and interests in closely-held corporations in the same manner as interests in pass-throughs); Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1770 (1999) (describing tax policy choices in integrating corporate and individual income tax schemes and discussing economic ramifications that would result); Harry Grubert & Rosanne Altshuler, *Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Tax Down to 15 Percen*t, 69 NAT'L TAX J. 633, 658–62 (2016) (proposing to tax corporate income at a low 15% rate and then imposing an interest charge on deferred tax liabilities). To address the global pressures on tax revenues from tax competition, Professor Avi-Yonah has also proposed a coordinated and uniform international withholding tax on portfolio investments. Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1666–70 (2000).

314. *See* Grubert & Altshuler, *supra* note 313, at 665 (describing how shifting the tax burden from the corporate to the individual sector would diminish the benefits from income shifting).

315. That is, the various corporate integration proposals may be understood as proper applications of the "neutrality principle" in contrast to the mistaken goal of seeking average neutrality across entities in the 2017 tax legislation. *See, e.g.*, DEPT. OF THE TREASURY, *supra* note 313, at 12 ("Integration would reduce and in some cases eliminate the distortions of business decisions . . . by coordinating the individual and corporate income tax systems . . . .").

foreigners.[316] The corporate system offers the benefit of indirectly taxing these otherwise tax exempt investors.[317] Shifting the burden from the corporation to the owners through integration may also require reforming the taxation of these exempt taxpayers.[318]

In the end, weighing these options—and particularly the choice between a relative corporate penalty and fundamental neutrality rule reforms—may also depend on the rate levels across the tax system as a whole. For example, assume Congress implemented a top individual rate of approximately 70% in accordance with Representative Ocasio-Cortez's proposal,[319] and then raised the corporate rate to within the range of 60–70% to preserve a relative corporate penalty for most taxpayers. These higher rates could have a much more significant effect on corporate investment across borders and may induce other tax avoidance behaviors not undertaken at current rates.[320] In this scenario, the neutrality rule option—and, in particular, some form of corporate integration—may be more desirable, even if a shift to taxing individual shareholders rather than corporate income might entail additional challenges, such as the treatment of tax exempt investors. Alternatively, in a tax system with lower rate levels (though still higher than under the 2017 legislation), simply reverting to a relative corporate tax penalty may be a more desirable method of breaking the ratchet.

316. *See* Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, 151 TAX NOTES 923, 923 (2016) (estimating "that the share of U.S. corporate stock held in taxable accounts fell more than two-thirds over the last 50 years, from 83.6 percent in 1965 to 24.2 percent in 2015").

317. *See* SHAVIRO, *supra* note 22, at 155–56 (discussing the question of how tax-exempt shareholders should be treated under corporate integration).

318. Eric Toder and Alan Viard suggest, for example, imposing a 15% tax paid on interest to tax exempt institutions and retirement plans, "to limit the . . . benefit these taxpayers receive from a lower corporate tax rate." TODER & VIARD, *supra* note 313, at 2.

319. *See supra* note 6 and accompanying text.

320. MNCs still engage in significant profit shifting even with lower corporate rates, and therefore may not shift significantly more profits at even higher rates. *See* Clausing, *supra* note 129, at 29.

CONCLUSION

The progressivity ratchet begins with a basic insight from the tax policy literature. A preference for one portion of the tax base can undermine the effectiveness of tax increases on other portions of the base. Because of the preference, the tax increases will raise less revenue at a higher efficiency cost. As a result, policymakers will be limited in their ability to progressively raise more revenue from the wealthiest taxpayers if they face one or more of certain political constraints in raising taxes on the wealthy: (1) a concern with the efficiency costs of taxation; (2) challenges to raising revenue through further increases to the top rates; or (3) a decision to tax the wealthy at the revenue maximizing rates.

In turn, the neutrality principle suggests that policymakers can mitigate the costs and revenue loss from taxation by treating close substitutes neutrally. This Article builds on these principles to evaluate the case of a new tax preference introduced as a response to an initial preference and to explain why the legal rules defining the new preference will determine whether it mitigates or compounds the tax ratchet from the initial preference.

This Article then applies this framework to reevaluate the new preferences for business income in the 2017 tax legislation and to explain why these changes will obstruct future progressive income tax reforms. Many commentators criticized the design of the new "pass-through" deduction but praised or tacitly accepted the corporate rate cut as a response to international pressures. This Article's framework offers an alternative understanding of these changes and explains why they both represent similar mistakes that will compound the progressivity ratchet and limit the revenue raising potential from future rate increases on taxpayers with the highest incomes.

Understanding the 2017 tax legislation through the lens of the progressivity ratchet also suggests the possible paths forward. This Article explains how policymakers can weigh different options to correct the mistakes in the 2017 legislation and thereby enable future progressive income tax reforms.